The New York Certified Public Accountant

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AN ADIRONDACK VIEW

Cash McCall is the name of a book listed as a current best-seller. On page 8, the manager of the Hotel Ivanhoe is described as looking like a certified public accountant on a skim-milk diet. We don't know of such a member in our New York Society—the one we see in the mirror takes his milk homogenized—yes, from a client.

Well, Cash, himself, is quite a character. Big, strong and friendly. Hated and praised. Invests a million dollars fast—and makes it the same way. Has his firm of CPA's working all night at a moment's notice. And his lawyers working with them.

The book is full of our words—capital gains, loss carry-overs, double martinis, confidential reports, hidden assets, trusts, reorganizations, test checks, et al.

Yes, the story includes some reference to God, the Main Line social set, sex, and mystery—it meets the four tests. But you will need to read it yourself to find how it comes out. Like other CPAs, our reading time for a book of fiction is six months to a year. We started this one in March—this year.

LEONARD HOUGHTON
"Adirondack Chapter
Saranac Lake Branch"

Book Reviews

Case Studies in Auditing Procedure: No. 10—A Smaller Commercial Finance Company.

Sponsored by the Committee on Auditing Procedure, AMERICAN INSTITUTE OF ACCOUNTANTS, New York, N. Y., 1956. Pages: 43; fifty cents.

This is the tenth in a series of case studies sponsored by the Institute's committee on auditing procedure. Each case study is a description by a certified public accountant of an actual audit conducted by his firm. The case studies are published to illustrate the application of auditing procedures for practicing accountants and accounting students.

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Book Reviews

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Governmental Accounting, Second Edition

By R. Merrill Mikesell. RICHARD D. IRWIN, INC., Homewood, Illinois, 1956. Pages: xii + 738; $8.10.

This book is a revision of the first edition published in 1951. It contains an excellent description and discussion of the accounting principles, standards, and procedures applicable to state and local governments, as well as two chapters giving a brief outline of accounting for hospitals and educational institutions.

The subject matter relating to governmental accounting follows the accounting principles, standard procedures, account classifications, and terminology recommended for use by the National Committee on Governmental Accounting, and incorporates the changes made by the Committee since the first edition was published.

While practically all of the literature published in recent years follows the teachings of the Committee, experienced practitioners in the highly specialized field of governmental accounting know that some of them are not entirely practicable or desirable, and that more realistic and less complicated treatments are being successfully used by many governmental units.

Knowingly or not, the author has built up an excellent case for discarding the so-called "accrual" basis for recording of governmental revenues. In making his comparisons with commercial accounting, he states "In general, accrual accounting is recommended for government. This means (a) that revenue should be taken up in the period in which it is earned, even though not received; and (b) that expenditures should be recorded in the period in which the obligation is incurred, even though payment is deferred to a subsequent period".

In another paragraph, he states "Because some governmental revenue cannot be collected even though legally accrued, many governmental units have adopted what is called a 'modified accrual basis', which consists of accruing costs but not revenue". In his discussion of revenue accounting in Chapter 5, the statement is made that "Even though taxes become liens upon the underlying property, collections in a given period sometimes fall substantially short of the amount levied. If expenditure commitments are based upon the amount levied but actual collections fall short of anticipations, the result may be a condition of financial stringency for the taxing fund. With these facts in mind, some governmental units record the taxes as charges against the property owners but record revenue on the basis of collections".

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Book Reviews

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The author further points out that taxes in the non-property category do not lend themselves to use of the accrued basis, and that many other revenues must be accounted for on a cash basis. To sum up, it would appear that property taxes and a few other receivables, the amounts of which are determinable, are about the only revenues which can be treated on the accrual basis. Since it is not possible to accrue all revenues at the time they are earned, this reviewer believes that the National Committee on Governmental Accounting should re-examine its stand in this matter and discard its advocacy of the "accrual" basis insofar as it relates to revenues.

The subject of governmental accounting is covered in 20 of the 22 chapters in this volume, and is illustrated with 153 illustrations which include specimen financial statements and schedules and samples of accounting forms required for use. At the close of each chapter is a series of questions and problems dealing with the subject matter. Many of these have been selected from those used by the American Institute of Accountants in preparing the examination papers for certified public accountant which are now used by all the states, four territories and the District of Columbia.

The four appendices include a listing of municipal accounting terminology, a summary of principles and standard procedures recommended by the National Committee on Governmental Accounting, four mathematical tables for use in accounting for Sinking Funds, and a standard audit procedure for municipalities as compiled by the California Society of Certified Public Accountants.

Governmental Accounting should prove an excellent textbook for students and a valuable reference for teachers, practitioners, and public officials.

ERNEST W. CARR

New York, N. Y.

Auditing—Principles and Procedures, Fourth Edition

By Arthur W. Holmes. RICHARD D. IRWIN, INC., Homewood, Illinois, 1956. Pages: xiv + 808; $8.10.

This is the Fourth Edition of a textbook in auditing principles and procedures designed for use by both the student and the practitioner. The major changes from the earlier editions are described by the author in the preface as follows:

"Those familiar with the preceding editions will recognize that, while the essential aims of the book remain unchanged, the Fourth Edition represents a thorough revision. Internal control is emphasized, and reliance upon internal control has

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Book Reviews

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been moved to more prominent positions in the book. Internal auditing has been given increased prominence. The treatment throughout the text has been modernized in all respects; procedures, standards and principles are those currently accepted. Pronouncements, research bulletins, and statements of auditing procedure issued by the American Institute of Accountants, the pronouncements of the American Accounting Association have been woven into the discussion, as have the regulations of the Securities and Exchange Commission."

The opening seven chapters discuss thoroughly and amply illustrate various general and preliminary matters: Auditing Concepts; Reports—Staff Organization; Professional Ethics and Legal Responsibility; Internal Auditing — Internal Control — Fraud; Starting the Audit; The Audit Program and Audit Working Papers; Original Record Examination. The last-mentioned chapter contains an excellent and up-to-date discussion of testing and sampling, and is especially recommended by this reviewer not only to students, but also to the active practitioner.

The next portion of the book deals with the methods and procedures used by the auditor in connection with the verification of the items in a balance sheet and income statement. These chapters are divided into three sections: Section I contains a complete internal control questionnaire; Section II outlines and discusses in detail the audit program; and Section III presents the accounting considerations and financial statement standards.

The concluding chapters comment fully on the preparation of financial statements, audit reports and the work of the public accountant in the field of management consulting.

The book is replete with examples and illustrations. At the conclusion of each chapter there are questions and problems; many of these are taken or adapted from the uniform CPA examinations.

There is also a separate set of illustrative audit papers which should be most beneficial to the student. This reviewer especially approves of the inclusion, on the various analysis sheets, of the comments by the auditor regarding the work done.

BENJAMIN NEUWIRTH

New York, N. Y.

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Local boy makes good

WHEN THE LATE Ebenezer Hubbard, a patriotic Concord man, left a bequest for a local statue, there luckily happened to be a real sculptor close at hand.

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EMANUEL SAXE, *Managing Editor*

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The President's Page

Professional Conduct—Up-to-date

I DOUBT that anything could be more illustrative of the amazing growth and vitality of our profession than the current interest in the ethical aspects of CPA practice. Almost overnight, it seems, rules and standards, developed thoughtfully over a period of more than half a century and found adequate to our needs throughout that time, appear to call for review, revision and extension.

It has been well stated that acceptance by its members of rules of conduct is one of the distinguishing charateristics of a profession. While we can take pride in the growing recognition of our professional maturity, it certainly cannot be charged that the term, as applied to us, has any connotation of *laissez-faire*. In our own Society, a most active committee has just completed a comprehensive review of our rules. Even before the ink is dry on that committee's recommendations, the American Institute has substantially enlarged its Committee on Ethics specifically for the purpose of undertaking studies at the broadest level. Contemporaneously, John Carey is working on a revision of his authoritative book on the subject.

Why all this sudden activity in this area? The question is perhaps best answered by indicating just a few of the problems which seem to call for current decision.

Our rules have heretofore pivoted around a concept of "independence", derived from our issuance of opinions respecting financial statements. Our services are now expanding, however, into areas, such as management and taxation, where some degree of advocacy and participation are involved. Are the same rules still applicable?

What standards of competence and prior experience should be a prerequisite to the offering of management services? Should these standards be required of the firm itself, or of a partner, or of an employee? Is it satisfactory to engage the services of another firm possessing them?

Assuming that we have something to offer in the fields of automation and electronics, should we be permitted to offer such service through servicing companies? If so, how could they survive in competition with the salesmanship and advertising of reputable machine companies and others?

Should integrity, as well as independence, be one of our basic standards? This question has especial significance in relation to tax practice.

Should the lines between outright crime, breaches of ethical conduct and breaches of professional conduct be more clearly defined?

Should rules of professional conduct relate only to matters affecting the public interest? If so, can we

justify reference therein to agreements between ourselves (e.g., as to staff raiding)? Or with other professions as to jurisdictional matters?

These are a few of the problems. They are not simple ones. Their solution will involve a judicial approach and breadth. It is good to know that our deliberations regarding them can be relatively unhurried. In the meantime, we are a part of a profession whose principal product is the result of judgment. Our members should have little difficulty either in differentiating right from wrong or in avoiding the wrong path when it has been identified. As a general rule it might be stated that, regardless of written rules, the very existence of doubt in the mind of a professional man as to the propriety of a possible course of action should counsel him against it.

* * *

This is this President's last President's Page. He will really miss the opportunities that have been afforded him through its medium to talk informally to a stimulating membership from time to time. Particularly will he miss the letters of response which these pages have inspired.

HAROLD R. CAFFYN
President

How to Start a Budget Program in an Established Company Not Used to Budgeting

By Alfred O. P. Leubert, C.P.A.

This paper describes the four basic steps to be taken to develop a budget program in a small company. It points out the need for supervisory participation and the necessity for selling the program at the foreman level.

Never before has business been so conscious of the necessity for and the benefits of a budget program. In large companies, those that have a budget department or a budget controller, the institution and implementation of a budget program is rather complex because of the many products, departments and activities to be budgeted. But in these large companies, there is usually available a staff of experienced and qualified budget technicians who have the time and tools to install and develop the budget program. In medium-sized companies, the activities to be budgeted are not normally as complex, but the staff available to do the job is not as complete, and there is more burden placed on the controller, as the financial officer of the company, to install, expand and police a budget program.

Alfred O. P. Leubert, C.P.A., is a member of our Society and of its Committee on Budgets and Budgetary Controls. He holds the degrees of B.S. from Fordham University and M.B.A. from the Graduate School of Business Administration of New York University.

Mr. Leubert is Secretary and Treasurer of Old Town Corporation, Brooklyn, N. Y. He is also an instructor of Accounting at Pace College, New York.

This paper was presented at a technical meeting of the Society, recently held under the auspices of its Committee on Budgets and Budgetary Controls.

In the small company—the one which has developed to the point of having a controller—the problem of starting and installing a budget program is difficult. Assuming even that top management is completely sold on the necessity for the budget program, the task of getting it started, having it understood, achieving support for it, and deciding how rapidly it should progress and what it should encompass, is a difficult one. Most budget programs that fail in small companies do so because the pressure of getting one started, the demand for immediate results, and the failure to plan its targets, were objectives impossible of attainment without the guidance and follow-through of an experienced budget supervisor.

Let us now discuss how the controller, given a budget assignment for a small company, should start the program. Let us assume, for our discussion, that top management (that is the owner, or the principals) have fully endorsed the need for a budget program, and that the controller has a free hand to move ahead. And, let us further assume that our company is one that has been manufacturing and selling a given product for a period of years on a day-to-day basis, without any formal forecasts, budgets or centralized control activities.

Budgets—and a budget program—are similar to methods and procedures in that budgets can be developed, but

they cannot be installed. Budgets, unlike machines and equipment, are intangible and are the product of human effort. Machines can begin to produce results immediately after installation. A budget program produces results only after the program has been developed—and the results will increase as long as the development continues. The benefits and results will cease as soon as the development is discontinued.

Basic Phases of Budget Development

Here are the four basic phases for the controller to follow on a budget development assignment:

1. Analysis of past operations.
2. Discussion with operating personnel.
3. The first report.
4. Subsequent reports and follow-through.

Analysis of Past Operations

The starting point of any budget program begins with an analysis of past performance. Usually, a controller's management work will produce much of the statistical data required for budgeting. However, almost always much greater detail is required. Labor must be separated by department and elements, production must be analyzed by product and department, sales must be broken down by product and region, by customer and by salesman. It is not absolutely necessary at this stage that these analyses be complete to the extent that they represent ultimate detail. Reasonably useful analyses, which can be expanded and refined in a subsequent period, are all that are necessary. It is, however, most important that the controller's analyses of the past be complete enough for him to get a feel of the whole problem and for him to decide which are the most important elements to be budgeted. After completing the labor, product, overhead and sales analyses, the controller is ready to start the development of the program.

Discussion with Operating Personnel

Conferences with each department foreman, to ascertain work flow and to get a thorough appreciation of the foreman's problems of control, should be handled on an individual basis. The need for budgeting should be developed with the foreman or department head, and his ideas as to which element can be forecast or budgeted should be solicited. Although the program calls for budgetary control of all elements of costs, it is often wiser to pick just one or two to begin with and to control them through the program before attempting complete control of an entire department or cost operation.

When agreement is reached with a particular department head concerning the necessity for budgeting a special cost element, the next step is to agree with the foreman on how the particular cost is to be measured and the form of report in which the information will appear. The department head should have a strong voice in the decision as to how performance will be measured and how the information will appear on a weekly or monthly report. It is most important, even if the deparment head's ideas are not the most practical or complete at this stage of the program, that his ideas be given a fair chance and that he does not feel that a system of control is being imposed on him.

After completing the preliminary review with each of the department heads concerned, and having received their ideas of what final reports will mean most to them, the controller is now ready to make the necessary changes in accounting procedures, the chart of accounts and the form and content of reports to be issued. Although the initial budget program has as its goal the control of only one or a few elements of cost, it is important that any revisions in the accounting procedures or the chart of accounts be designed with the flexibility to insure their adequacy for future controls.

The First Report

After the first period of control has elapsed—a week or month, as the case may be, the controller with the help of accounting personnel should personally prepare the report of budget performance.

Comparisons shown on the report between actual performance should be analyzed first by the controller and then discussed with the foremen. This initial report will usually—and sometimes fortunately—develop wide variances between the actual and the budget. These variances should be analyzed with each foreman to ascertain whether the original budgets were developed on a sound basis, or whether actual performance was influenced by conditions beyond the foreman's control.

The occurrence of these differences in the first budget comparison afford a fortunate opportunity for the controller to discuss again the need for the budget within the department and for the company, as a whole. The success or failure of the budget program within a given department can take place at this point, if the department head does not understand why such variances occur. So too, out of the discussion of variances must come the methods and procedure of preparing future budgets and, perhaps, the additional items of costs that are to be controlled in the future. Changes should also be made in the reports that show variances, so that corrections can be incorporated in the next report.

Subsequent Reports and Follow-through

Subscribing to the premise that budgets are developed and not installed, it follows that a budget program must be followed through, supervised and policed. Budgets are not static but are flexible and must constantly be revised to take into account changing conditions, revised production and sales schedules, changed labor rates, changes in capacity. Budget programs should expand with the needs of the business and the initiative for the changes should come from the operating managers whose performance is measured by the budgets. If the controller is responsible for starting the program, his assignment is not completed until adequate personnel are assigned to police the progress of the program.

When operating personnel have been exposed to a budget program which they have had a part in setting up and in which they have had a voice in setting performance standards, little difficulty is experienced in having them budget and forecast future results. Budgets do not become unreasonable targets set by the financial department in order to squeeze more profit out of operations. They do become tools of operating foreman—tools that are as important as the machines, personnel and supplies used in production.

A Practical Application—Manufacturing Department

Analysis of Past Operations

The principles involved in getting a budget program started which have been enumerated above can, I believe, be successfully applied in most budget assignments. As an illustration, let me relate the story of a budget program with whose design and installation I was professionally involved.

This budget program was started with an analysis of past operations, labor costs, material costs, maintenance and other indirect costs, which were broken down by major departments. Administrative costs were segregated from selling costs, and sales were analyzed by salesmen who were assigned to marketing areas. These analyses were made by the accounting staff and the classifications established as temporary expedients were arranged in appropriate form for discussion with department heads. Preliminary drafts of reporting forms were made so that they would be available as required at the discussions.

Without going into all of the details of the discussion with the various department heads, I would like to refer to the various stages of budget development in one of the manufacturing departments. This department was supervised by a foreman who had many years of operating experience with the company, but he had not been accustomed to running a department with a budget. The foreman had no records of prior costs or production output. There were no records of hours put into production, idle time or indirect labor.

Discussion with Operating Personnel

The first discussion with this foreman set forth the facts that the management had plans for a large expansion of sales and production; that in order to develop the expansion program at the most economical cost it was necessary to budget expenditures; and that in order to compensate and reward department heads for their efforts, it would be necessary to measure their production in relation to their costs. It was emphatically indicated that the budget program could not be successful without the foreman's cooperation.

Specifically, the foreman was asked to spell out the main elements of cost and the matter of expenditures in each element of cost. His opinion was asked concerning which cost would lend itself best to budget control and how this control could be achieved. He was asked to list the names of each of the employees under his supervision by cost centers. This list was prepared at the conference and hourly rates were included and totalled by cost centers to determine the total hourly rate for each cost center.

In this particular department, it developed that overtime cost was an important factor. To begin with, it was decided to estimate overtime roughly as a percentage of regular payroll. This could have been calculated by the accounting department, but it was felt that it would be better to permit the foreman to guess at the figures and to see how close his own estimate of the cost came to future actual costs.

Payroll taxes, compensation insurance, repairs and maintenance, other expense and supplies, depreciation and other costs were discussed in general, but no attempt was made at this meeting to begin budgeting these elements of cost. It was decided that through the accounting department these latter costs would be segregated during the next month and preliminary budgets would be worked up after a month or two of experience.

A tentative departmental expense report was drafted to include all of the cost elements previously mentioned, and it was indicated that this report would probably have to be revised after a first report had been issued.

The First Report

The first report to this department showed actual direct labor, indirect labor, overtime costs and payroll taxes compared to the targets that had been set. Actual costs of repairs and maintenance, other expenses and supplies, depreciation, etc., were also included but without any budget comparisons.

The impression of this first set of statements was lasting. Actual direct labor was close to the target; overtime cost was substantially over the target. This made the foreman realize that his idea of overtime cost was not even close to actual and would probably never come close unless during the month he conscientiously regulated overtime hours in accordance with a predetermined target.

At this discussion of the first report, the foreman saw the necessity of budgeting all costs, and realized that it was to his interest to know just how much each of his departments were costing.

Subsequent Reports

Subsequent reports developed other deficiencies in the budgets and appropriate targets were set. Depreciation

was later set up for each of the departments based on the equipment used by each department. Proper identification and segregation of other costs were agreed upon after comparing these costs with temporary targets, and definite standards of costing and targets for respective costs were established.

The data that have been accumulated from these expense statements and the ability to measure costs of each department, seasonally as well as annually, now provide the basis for complete budgetary control over the conversion costs. The present program now calls for establishing a modified standard cost system, which would include material cost as well as labor and other expense control.

This budget program is by no means complete at this point. What has been finalized, however, is the fact that the manufacturing departments do operate against the budget and that foreman participation is necessary and is received; also, that the budget program must be continually developed and expanded in the future.

A Practical Application—Sales Department

The same principles of discussion, submitting of reports, and further discussions were applied to the sales forecasts and budgets.

Analysis of Past Operations; Discussions with Operating Personnel

Prior to discussion with the sales department, the sales volume based on past performance was ascertained for each salesman in each marketing area. At the first conference with the sales department, it was not necessary to explain the need for forecasts and budgeting and, therefore, the discussion centered mostly on how fine a control could be exercised during the initial period in budget development. At this discussion, almost arbitrary quotas were set for each salesman and for total sales volume, with the realization that because of changes in products as well as changes made in the sales force and its organization, several of the targets set would not be realistic. But it was agreed that after the first three months, each of the targets set would be studied and revised, if necessary.

It was realized at this discussion that it would be desirable to establish product quotas for each marketing area and that future sales would be analyzed by products for each of these areas. Targets, however, for product sales were not set by marketing area but only for the company as a whole. Similarly, agreement was reached with respect to classifications and allocations of sales expenses to the various marketing areas and functional units of the sales department. Reports were drafted to show sales volume by salesman measured against the quotas set, and expense statements were drafted to show actual expenses measured against expense budgets.

The First Report

After the first reports were issued, errors in quotas and expense budgets were apparent. It was decided that no change be made until after the first three months had elapsed. It was also decided at this conference that from the long-range viewpoint, a finer breakdown of product sales would be necessary in order more effectively to arrive at sales quotas by products for each salesman. This became a long-range program because of multiplicity of products involved.

Subsequent Reports

Subsequent reports developed other deficiencies in the original quotas and budgets set. Quarterly changes were made in the budgets and the sales quotas assigned to various marketing areas.

Recently, the subject company has been working on its current quotas and

expense budgets and, with the help of tabulating equipment and a final method of product coding, it will be able to establish annual quotas by customer, by salesman, and by marketing area. Moreover, with the new product-coding system, by the use of tabulating equipment the firm will also be able to accumulate statistics on the volume of sales by product, by customer and by salesman, thereby enabling it to forecast future sales by product, by customer, and by salesman.

However, such a budget program is never really completed. It will always require changes to incorporate final break-downs of expenses for sales volume, product and customer information.

Summary

Very often the best advice is that which is the product of bad experience and is expressed in negative terms. For the controller who is charged with the responsibility of starting a budget program in a company not accustomed to budgeting, I offer the following cautions:

1. Don't rush the program beyond the capacity of the operating personnel to absorb it.
2. Don't complicate reports with unnecessary data and calculations.
3. Don't forget that operating personnel are not trained financial experts.
4. Don't be impatient with slow progress in expanding the program.
5. Don't use accounting terminology where shop language serves just as well.
6. Don't forget that the program must be sold to operating men and that they must know the reasons why.

Today's Costing Methods and Their Objectives

By LAMBERT H. SPRONCK, C.P.A.

Though automation will not change the essentials of business, it will place an unusual degree of emphasis on planning. Many more executive decisions will become irrevocable, while fewer will be reparable or reversible; as a result, poor business decisions will not be tolerated. This paper demonstrates a means of reporting business transactions at the point of decision, so that executives may then perceive the effect thereof and be able to anticipate, to the extent possible, their effect on the financial statements.

Management Planning

The objective of today's costing methods can be expressed very simply: Make them fit into the management plan of your company. The most encouraging advancement in cost accounting in the last ten years is, I believe, that it is no longer considered as an end in itself, but, instead, is an important segment in management planning and control.

Management of modern business has continuously become more complex and challenging. A major problem in recent years has been to match the increase in the costs of wages, salaries, materials and other operating expenses with comparable increases in sales prices. Industrialists and businessmen facing this problem have sought to use every tool of modern management available to improve profits from operations.

The use of such tools as coordinated short- and long-term plans has become evident in an increasing number of companies in every field. Their executives have learned how successful results can be achieved through planning; planning for a coming year by studying the specific manpower, materials, and other costs and expenses necessary to achieve attainable goals; and extending such planning over a longer term, giving careful consideration to the economy and outlook for the regions in which their businesses are conducted. Methods of estimating revenues, costs, and expenses have been simplified. Means of preparing annual budgets and reports of performance have been developed for virtually every kind of business. The benefits of such planning have far outweighed the relatively low costs involved in their preparation.

Although a budget may not be an absolute necessity, a management which operates without one is at a definite disadvantage. Where budgets are in use, key employees are usually more cost conscious and better in-

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formed. They have a share in planning, and exercise a greater degree of control over operations. They can make and alter plans with greater facility, and have available the source data to discover and promptly analyze deviations from plans. A management which has available detailed estimates of future results for current analysis and review is in a position to do a better management job.

Stability

Integrating cost accounting with budgeting and with procurement and personal planning has given stature to the cost accountant. He has been able to relax his efforts to prove the need for cost accounting. There was a time when the cost accountant felt that he had to convince management that pricing policy should be based on costs. While it is a basic economic principle that in the long run cost factors cannot be ignored in pricing policies, nevertheless, informed cost accountants recognize today more than some years back that costs serve only as a guide and not as a rule. Competition and only competition sets the day-to-day price. In many companies some product lines are sold at a lower markup than others merely because of the competitor's price, and we vindicate this policy by the old saying that ringing the cash register pays for the overhead.

Today the cost accountant spends more time making the costing method fit into the budget plan and less time in allocating, prorating, and redistributing overhead expenses.

Simplicity

There is a definite trend in today's costing methods toward simplicity. Cost bookkeeping procedures necessary to make up the month-end statements have been simplified in many instances by avoiding the endless pricing and extension of innumerable items produced and shipped. For example, a can manufacturer will consolidate his unit standard costs in such a way that a single "all-label" can standard is used for all of the many customer brands using the same type can, instead of using hundreds of customer label can standards for pricing and extending finished products and cost of goods sold.

Electronics

A word or two may be mentioned about electronic data processing in connection with simplification in cost accounting. The application of electronics in accounting has induced companies to go a long way in achieving standardization of accounting procedures simply because electronic machines work most efficiently when they have a lot of work to do in one or more fixed ways. It is desirable to eliminate every possible exception or special handling of accounting transactions. On the other hand, because electronic calculators can handle so many figures so fast, it is possible to lose sight of the necessity of eliminating details and unnecessary paper work. What is sometimes forgotten is that the original processing of paper work before feeding it into the machines is the costliest element in accounting in terms of clerical costs of typing, classifying and checking. The answer is, I believe, to clean house of unnecessary paper work and detailed reports which are seldom read, before starting an electronics program. It is still less expensive in many instances to make a thorough analysis of costs, once a year, by hand, than it is to make the same analysis 12 times a year on a high-speed electronic calculator.

Cost Accounting

New Developments in Costing Methods

In the first few years after World War II, many companies directed attention to evaluating their cost systems to see if they fitted the needs of their postwar operations. I can remember

citing at that time three objectives of a cost system:

1. As a guide in setting selling prices.
2. To improve management control.
3. To account for inventories and cost of sales in determining net income.

I suppose that practically every work on cost accounting paraphrases these three objectives to some extent. Now there is a fourth objective of cost accounting—namely, Planning.

I have already discussed the integration of cost accounting in management planning. It is the general trend today. On the other hand, I have had some difficulty in identifying new improvements in cost accounting techniques in the last decade. Possibly our preoccupation with advances in office machines and electronics in accounting has left little time for development of new costing methods. There are, nevertheless, a few trends or newly developed areas which I believe are worthy of mention.

First, there is a definite trend toward providing that factory cost records and accounts agree with the general books of accounts. In the postwar years the monthly statements of income have attained greater importance than ever before. Management wants them to be as good as the year-end financial statements and management is becoming more and more intolerant of major unexpected year-end adjustments. By making the factory cost accounts tie in with the general accounts, controls are established which reduce the occasion of error and provide better means of disclosing inaccuracies before month-end statements are typed.

Second, there is a trend toward a double standard in standard cost systems. In accounting for materials, some companies use one cost standard for inventory valuation and another for reporting currently on budgetary or departmental costs; the latter being used to measure utilization of materials, scrap losses, or as a goal for the buyers in the purchasing department. In accounting for labor costs, some companies with wage incentive plans take the position that standards for wage incentive purposes do not have to be used for costing purposes. By using two standards, current reports on performance can compare actual cost with shop standards which have been realistically set according to the actual processes currently used in the shop and on the basis by which labor is currently paid. By using a separate set of cost standards for inventory valuation and cost of sales purposes, month-end statements can be prepared more quickly and economically. Cost standards need be revised, possibly only once a year. These cost standards do not purport to represent current shop standards; thereby eliminating the costly process of resetting standards and revaluing inventories during the year. However, differences between the shop and the cost accounting standards are usually recognized and recorded as variances.

Third, there is a trend toward the greater use of quantitative data in budget reports to operating supervision. It has been found that in many companies dollar amounts are not grasped by production men as easily as we accountants think. In order to make budgets more realistic and more workable, number of personnel, man-hours, units of production, machine-hours, kilowatt-hours, quantities of supplies, tons of scrap, etc., have been highlighted in budget reports. At the same time certain dollar comparisons have been shown only in summary totals or else have been eliminated.

Fourth, there is a trend away from the automatic calculation of flexible budgets based on inflexible charts and tables. Companies have found that they can put a budget program across to sales and production personnel much more readily if they demonstrate that the budget is realistic; that it makes

allowances for unforeseen extraordinary expenditures or situations. Many companies adjust their budgets quarterly (even monthly) to keep them up to date in relation to business conditions. Separate studies and analysis of causes are made of variances from the long-term forecast. How to make a budget flexible is of lesser importance than the impression left on the operating executives that the budget is a realistic and attainable goal.

Fifth, there is a greater emphasis on distribution costs. The direction of sales distribution effort is the most important reason for distribution cost analysis in that it provides marketing executives with necessary information for planning and controlling their distribution effort. Cost determination and cost control are also objectives of distribution cost analysis.

It is an axiom that sales effort must relate to sales possibilities. "Controllership" by Heckert and Willson treats this very well: ". . . a number of business concerns that have achieved a reasonable degree of success in maintaining distribution costs at a satisfactory level in relationship to sales have used three basic tools: (1) Estimates of market potentials by territories, products, and types of customers, so that selling effort could be directed where the greatest sales potential lay, (2) Analysis of distribution costs to reveal the areas of unprofitability, in order to study the causes and take corrective action so as to make the selling effort profitable, and (3) Application of sales distribution cost standards to measure the degree of efficiency with which distribution activity is being performed."

Standard cost plans have been applied in many of the larger companies to distribution costs. However, the smaller companies have the same problem; but very few of them have developed comprehensive costing methods for distribution costs in the same way as they have for production costs. Many companies in this situation are presently investigating the advantages of formal distribution cost systems over their present methods of dealing with distribution problems.

Personal Observations on Cost Accounting

At this point I would like to add a few personal observations on cost accounting. I would like to ask, "Can your company afford the cost of cost accounting?" I do not intend, however, to include within the scope of this question the field of cost analysis, which can provide management with very valuable information, such as comparative costs of product lines, study of effects of volume and sales mix factors on profits, statistics relating to spoilage and material usage, manpower studies of requirements at various levels of productions, and periodic analyses of manufacturing expenses. On the other hand, the whole area of cost bookkeeping is questioned, especially the month-in and month-out calculations of unit costs, multiplications by units produced, allocations and redistributions of overhead expenses and the preparation of innumerable journal entries adding to and deducting from inventory accounts.

Whether or not certain cost accounting systems are distinguished by such titles as standard costs, actual costs, direct costs or job costs, nevertheless, many have their origin in the days of the model "T." The school of cost accounting of the nineteen twenties was tailor-made for the "efficiency expert" mind, especially when unemployment in the nation fluctuated in different years from two million to six or eight million. Reasonably adequate cost data could then be determined by dividing direct labor cost by a given quantity of units produced because direct labor was truly a variable element of cost. When production periods were of short duration, direct labor employees were laid off. Today the picture is changed. In the last

ten years or more, direct labor unemployment has not fluctuated greatly. Business has been good, competent productive labor is scarce and hard to replace; and, furthermore, companies have found that it is much more efficient to produce on a year-round basis. In addition, such factors as union contracts, seniority provisions, and forms of guaranteed annual wage agreements have tended to make the direct labor force a semifixed cost (even a fixed cost in some instances) rather than a truly variable element of cost.

In the years to come the production planning required for manufacturing by automation (and the comparable kind of planning which nonautomation competitors will be forced into) will cause a fairly normal pattern of production and of employment levels to be maintained. Costs under these conditions can be analyzed best on a "total cost" basis, that is, by looking at the entire production and labor picture for a whole year or for a seasonal business period. Only after the total annual payrolls (direct and indirect), together with all supplemental payroll costs (including taxes, insurance, pensions and other benefits), are analyzed, can true and proper cost of production relationships be established.

There is an analogy between cost accounting and the grocery business. In the nineteen twenties a grocery store could afford to pay clerks to select and carry merchandise to customers waiting at the counter. Today the economics of the grocery business makes it extremely difficult or practically impossible for this kind of service store to survive. The present day salaries of the grocery clerks are a good reason for this. The supermarket proved to be the only answer in the grocery business. The result—today, more goods are sold to more people at a much lower store cost per customer.

To complete the analogy: Few companies can afford to pay the present-day salaries of cost accountants and cost clerks required by certain cost bookkeeping methods. Periodic analysis of total costs will, I predict, prove to be the answer in the manufacturing industry. The result—more informative data will be provided to management at a much lower cost of cost accounting.

The Small Business and Cash Profits

The small business organization has essentially the same problems in management as the big companies, but the small company has two definite advantages. First, you can see it. With one good look, you can see the sales and production picture; you can judge how healthy its financial position is and what its potentials are. Secondly, it is easier for the small businessman to see that it takes more than paper profits to operate a business—that it takes cash profits. Even a company in a static position has the problem of replacing plant and equipment. In a growth situation the element of expansion is introduced with respect to the cash requirement of the company. For example, more cash is required to carry additional accounts receivable and larger inventories. The problem of maintaining an adequate cash balance is often more difficult for small companies than for large ones, and this accents the smaller companies' need for planning and cost control.

There are three factors in the business picture of the last ten years since World War II which make cash position and cash profits so important. First, taxes are not only higher than ever before but they are, for practical purposes, approaching a pay-as-you-go basis. A few years

ago federal corporation taxes could be paid in the following year in quarterly installments. This year all of the taxes for 1954 had to be paid by June 15, and two quarterly installments, equal to 10% of 1955 taxes, will have been paid by December 15, 1955. By 1959, 50% of taxes due will have to be paid by December 15. Secondly, salaries and wages present management with the weekly problem of cash. This becomes more and more acute as payrolls, plus the related costs of pensions, insurance, and payroll taxes, climb to a higher percentage of the sales income of most companies than ever before in their history. Finally, there is, in many companies, the phenomenon of profits in inventories resulting from a period of continuing rising market prices, when more and more dollars are tied up in inventory without corresponding increases in the quantities of stock on hand.

When we speak of objectives we must recall that fundamentally the first objective of accounting is the determination of income. A few moments ago I spoke of cash profits and of net income after taxes. To trained accountants like yourselves there is no confusion in your minds with respect to these two concepts. Your professional training and years of experience enable you to grasp each one clearly; in one situation where net income is the deciding factor, or in another situation where cash or cashable profits are at issue. However, you undoubtedly recall an occasion when you were hard put to explain the difference between these two figures to an executive in your company, especially to a man who has come up through the ranks in sales, production or engineering.

If you have faced this problem you will be interested in the remaining part of this talk. It outlines what I believe to be a new approach to reporting to management, and a valuable supplement to your present method of accounting for month-to-month operations. I am presenting it now for two reasons: First, to solicit your criticism, especially if you do not believe that this idea has as much merit as I do. Secondly, to receive your suggestions and comments if you believe that it has a very definite appeal to management. I call this method "Reporting at the Point of Decision." I submit that its principal attribute is that it speaks in the language of decision-making executives, the men who run your business but who do not have your accounting background.

We all recognize the advantages of and necessity for consistency in financial statements. Reporting at the Point of Decision in no way proposes to run counter to the accepted principles of accounting and statement presentation. The concept is, in a sense, statistical; it is intended to supplement conventional financial statements.

The annual reports to stockholders of many progressive companies frequently incorporate one of the principles underlying this approach to reporting. Their statements of income in many cases contain language like "We paid to our employees" and "We paid for materials, supplies, and services" in place of the more conventional presentation of a single amount labeled "Cost of Sales." At one time only the condensed statement of income on page one of the report, or in the president's letter, contained such language. It would make an interesting study to determine why this kind of language was addressed to the owners of the business, the stockholders, on the very first page of the report; and why, what may be described as accountant's language, was used on the last page of

the report on the statement of income adjacent to the C.P.A.'s certificate.

Reporting at the Point of Decision

Suppose for a moment that we were sitting at a conference table with the chief executive of your company and were reviewing the financial statements for the ten months ended October 31, 1955, and I said to him: "Mr. Smith, you incurred that loss in August when you signed the purchase orders for the materials, not when you read about it on the financial statements in November. Salesmen's orders from customers in June and July were fifteen per cent below your sales forecast. When you failed to reduce expenses and eliminate overtime, you were in trouble. The excess inventory on hand at October 31 did not just happen when materials beyond your requirements were delivered and recorded in the inventory accounts in October. The vendors were actually manufacturing your orders in August and September.

"The point of decision was in August when you put the purchase orders in the mail box. You should have been informed in August or September of the effect of this decision on your income or loss for the year; you should not have had to wait until the following November when the accountants prepared the financial statements for the ten months ended October 31."

If these hypothetical remarks point up a situation which has occurred many times in the past in large companies as well as small, then executives and accountants would be well advised to re-examine their approach to internal reports to management.

I believe that these remarks apply also with respect to automation in industry.

Automation will not change the essentials of business; people and companies will continue to buy and sell, to make and ship goods; accountants will continue to report on the results of operations. But, automation will place an unusual degree of emphasis on planning. Decisions made by executives with regard to the sales program, production plans, material purchases, and manpower requirements will be much more important in that so many decisions will be irrevocable, so few reparable or reversible. Automation will be as intolerant of poor business decisions as aviation has been of human error or malfunctioning equipment.

If so much depends on the decision and so few decisions once made can be changed, then we should provide for some means of reporting business transactions at the point of decision. Executives should be able to see the effect of their decisions at the time the decision is made; and should be able to anticipate, to the extent possible, the effect it will have on the financial statements.

In the succeeding part of this talk I hope to stimulate discussion by presenting what I believe is a new approach to reporting to management. You may ask if the same results cannot be accomplished by footnotes or explanatory paragraphs on the existing form of month-end financial reports. The answer is that if this approach is more informative to management, then that is a good argument for keeping the kind of subsidiary records necessary to present statements in a manner which is coincident with executive decision. Basically, this approach involves a shift in emphasis and timing; it does not change the substance of accounting practice.

Sales—Orders from Customers

When one executive meets another for lunch and asks, "How's

business?" and the reply is "Fine, better than last year," I dare say that in nine out of ten instances their understanding of the term "business" is not shipments or even profits. A businessman invariably thinks of orders from customers as the true barometer of his business. In companies where today's orders are next week's or next month's shipments, the point of decision is clear; it is the receipt and acknowledgment of a customer's order; the actual shipment is, in a sense, anticlimactic. In a going concern an order is processed as a firm order as soon as it is acknowledged. Therefore, in Reporting at the Point of Decision, such transactions are accumulated daily. By so doing you are stating simply that your salesman or customer has sent you an order and therefore you have made a sale.

In a number of companies, savings in clerical cost have been realized by processing sales at the same time as customers' orders. Companies which ship from stock or from inventories of finished goods or parts have found that the most efficient method of handling customers' orders is to first check the availability of the merchandise, and then, if the goods are in stock, to type the invoice copies simultaneously with the necessary shipping papers, sales orders copies, and acknowledgment to the customer. Other subsequent steps in the sales accounting and clerical routine can also be eliminated by a one-time handling of the transaction. Where electronic or integrated data processing systems are in operation, the coding and recording of the sales invoice at the same time the order is processed is also more efficient because of the one-time handling.

Costs

The next logical step in Reporting at the Point of Decision is to accumulate costs at the time merchandise or materials are purchased. Under this concept, sales orders are not thought of as being shipped "out of" inventory. If a company is on a going concern basis every article or part shipped must be replaced in order to carry on the business. Only a company going out of business or one with excessive stocks on hand can say that it is shipping "out of" inventory. If we consider every purchase of material as a replacement of stock, then the cost of that purchase is the cost of the customers' orders. We accumulated the amount of sales orders at the time customers' orders were acknowledged; accordingly we should now accumulate cost at the time we issue purchase orders to make or replace what we sold.

In the same manner, this concept can be applied to the labor element in cost inasmuch as labor is employed to make or replace manufactured goods sold on current orders. The total payroll paid to employees, therefore, whether direct labor, indirect or overhead labor, should be accumulated currently and related to current sales orders received. The point of decision with respect to labor is the day management puts a man on the payroll. From that moment on the employer is incurring cost which should be recognized as a current cost of doing business. The only exception to this position should be if there is specific evidence to show that a part of the labor is producing inventory or stock which is in excess of the current year's or season's requirements but is required for sales of the next year or the next business season.

In order to match current income of a business with current costs according to the concept of Reporting at the Point of Decision, the amount of incoming sales orders are related to the sum of the purchases

EXHIBIT A

	THE A. P. D. CORPORATION						
November 21 1955	THIS MONTH TO DATE 15 Working Days Out of 22			THE "TODAY" REPORT	THIS YEAR TO DATE NOTE: Heavy Lined Squares Indicate Adverse Condition		
TODAY	Actual	Forecast	Actual Over or (Under)	(In Thousands of Dollars)	Actual	Forecast	Actual Over or (Under)
$ 117	$ 1,476	$ 1,600	($ 124)	1. Sales — Orders received from customers	$17,239	$16,500	$ 739
58	665	700	(35)	2. Procurement — Purchase orders mailed to vendors and services received	9,321	8,400	921
27	414	400	14	3. Payrolls paid or accrued and supplemental costs 4. Manpower on the payroll Actual —1,347 Scheduled—1,300	6,536	6,600	(64)
32	397	500	(103)	5. Income at the Point of Decision	1,382	1,500	(118)
2,509	1,300 1,250	1,400 1,200	(100) 50	6. Cash Receipts Disbursements	10. Current Position "Cash and Cashables"		10a. Working Capital (Current Position plus Inventories)
5,472				7. Accounts Receivable (Unshipped orders amount to $2,118)			
4,702				8. Accounts Payable (Purchase commitments outstanding amount to $2,824)	$3,279		$7,787
4,508				9. Inventories Finished —$2,714 Manufacturing—$1,794			
93	1,270	1,200	70	11. Production	16,470	15,000	1,470
122	1,550	1,500	50	12. Shipments	15,830	16,000	(170)

made of merchandise, materials, supplies and services, plus the total payrolls paid or accruing to the employees necessary to carry on that business during any given period.

Daily Reports to Decision-Making Executives

Reporting at the Point of Decision is intended to have three essential features: 1. Sufficient supplementary records are maintained so that reports can be made up in the way businessmen think; in the way they work, decide, and act. 2. These records disclose the results of executive decisions as close as possible to the period in which the decisions are made, not after the fact. 3. Results are reported daily.

A sample of the latter feature is the "TODAY" report, Exhibit A, which presents on one page twelve salient factors about the business. Just as election results can be forecast by tabulating early hour returns from representative districts and relating them to past performances of these same districts, so also can business profits be estimated. Three things are necessary: First, study and establish the trends of orders received from customers, purchase orders mailed to vendors, and payrolls in the early months of prior periods in relation to final profits or losses from operations of those periods. Second, prepare a forecast of this year's sales, procurement and manpower in terms of day-to-day operations and anticipated decisions. In other words, estimate how much of the customers' orders can be anticipated in January, in February, and so on; how much in the first ten days of the month, and so on. Third, prepare daily a status report which shows how month-to-date figures compare with the proportionate share of the month's forecast, and how the year-to-date actuals compare with the over-all forecast. Estimates of year-end profits or losses may be made by studying how early months' results vary from those of prior years.

The key figures in the sample "TODAY" report are found on the line which shows by how much the orders received from customers exceed the sum of purchase orders mailed plus payrolls to date. By analyzing the over and under forecast amounts in these categories, especially where adverse conditions are indicated, the decision-making executive can see the storm warnings on the barometer. The "TODAY" report is, therefore, a means of calling attention to these conditions which directly affect profits when the executive still has time to do something about them.

Reporting at the Point of Decision can become a very effective tool of management because it highlights the three key elements of running a business; sales, procurement, payrolls. The "TODAY" report is a necessary link in the chain between actual decisions and month-end financial statements. It is timely; it can be prepared economically. With the application of electronic or integrated data processing equipment, the "TODAY" report could be tabulated for up-to-the-minute presentation on the office wall of the president of a nationwide multiplant corporation in the same way as the market prices are in a stockbroker's office.

What Price Professional Glory?

(For Unincorporated Business Tax Purposes)

By MIRIAM I. R. EOLIS, C.P.A.

This paper reviews and summarizes the criteria by which the courts have heretofore decided whether an activity was professional in nature, within the meaning of section 386 of the Tax Law, as a basis for making current judgments with respect to new situations.

ATTAINMENT of the title of professional is an enviable status in our society. Theology, law and medicine have known the security and dignity of the title for centuries. However, in the rapidly changing world in which we now live, new fields are constantly reaching for the harbor of professional acknowledgment, but society, and the already accepted inner circle, are slow to include the newcomers in their haven.

Even the tax laws, are designed to give preferential status to those fields of endeavor exalted into the professional aura. The State of New York, for example, has seen fit to tax business in the corporate form under the Franchise Tax Law, and in the unincorporated form under the Personal Income Tax Law. However, should the title of professional attach to the business activity, an exemption from tax is granted. Thus have the lawmakers seen fit to grant their approbation. Like society, though, the law has been loathe, and even slower, to extend the cloak of exclusiveness to the newly developing professions.

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Profession Defined

The Tax Commission of our state has defined a profession by regulation[1] as any occupation or vocation, in which a professed knowledge of some department of science or learning is used by its practical application to the affairs of others. It has gone on to say that the word implies attainments in professional knowledge, as distinguished from mere skill. The definition, however, when applied, results in some greatly diverse and inconsistent conclusions. For example, how does one justify the application of the appellation of professional to a certified shorthand reporter,[1] and deny it to a trained economist with four degrees?[3] Of course since the law is strictly, more often than loosely, construed, and since taxpayers have the human frailty of reaching for a tax exemption rather more often than less, the exemption has been sparingly granted, both by the Tax Commission and the courts.

Let us review what the "law giveth", and what the courts "taketh away". The Tax Law[2] imposes a tax on net

[1] Regulations, Article 6.
[2] Tax Law, Section 386.
[3] *Matter of Jules Backman*, 279 A.D. 1115; aff'd, 305 N.Y. 839 (1952).

incomes of unincorporated businesses, but specifically excludes the practice of law, medicine, dentistry, and architecture which, under existing law, cannot be conducted under corporate structure; and further excludes any other professions in which more than eighty per cent of the gross income is derived from the personal services of individuals or partners, and in which capital is not a material income-producing factor.

Exempt Professions— per Tax Law

Thus the Tax Law has set up certain criteria in its own body. It has named four specific professions. It has also extended its relief to other professions which obtain substantially all of their income from personal services, without a significant use of capital.

Exempt Professions— per Regulations

The Regulations[1] issued by the Tax Commission elaborate what, in its opinion, is the meaning and intent of the statute. Professions other than law, medicine, dentistry, and architecture have been named by the Commission to include accounting, certified shorthand reporting, chiropody, dental hygiene, engineering, optometry, osteopathy, pharmacy, physiotherapy, teaching, and veterinary medicine and surgery.

Exempt Professional Practice Combined with Business

The Regulations[1] further instruct us that all professionally licensed individuals, named specifically in the Law or Regulations, are not necessarily exempt from the Unincorporated Business Tax. For example, a lawyer who conducts a real estate or insurance business does not by reason of his lawyer's cloak escape; nor does a physician who operates a drug store; nor a dentist who conducts a dental laboratory. Where professional practice is combined with business, the Regulations[1] permit a severance of the activities to allow partial exemption. For example, if a pharmacist operates a drug store, as well as a pharmaceutical establishment, he is given the privilege of segregating or prorating his professional earnings from his business income. Only if the separation cannot be made does he become fully taxable. Similarly, an optometrist, who sells optical goods, would be given the opportunity to earn exemption from tax on his professional earnings separated from his business income.

The Regulations[1] elaborate on the law by restating that eighty per cent or more of the gross income of a professional individual or partnership must be derived from the personal services of the individual or partners. Should twenty per cent or more of the gross income be derived from sources other than professional effort, the entire income becomes tainted and subject to tax. While the personal services must be performed by the taxpayer, he may employ assistants to perform part of the work. However, in such event the taxpayer must give personal attention to the work performed, he must consult with clients, he must guide and direct the work procedures of his assistants, and he must supervise the formulation of advice and conclusions given to clients. Furthermore, in the event of the death of a professional individual, for example an accountant, optometrist, or pharmacist, should his organization be continued, the tax exemption would not apply to his estate or executors.

Capital as a Material Income-Producing Factor

The Regulations[1] interpret the meaning of capital as a material income-producing factor. Capital is not deemed material to the production of income if it is utilized for the purchase of furniture, equipment, tools and the like. For example, an engineering firm

[1] See note 1, *supra.*

that invested funds in its business in order to purchase furniture and to meet its payroll, would not be using capital as a material factor in the production of its income. On the other hand, the same engineering firm, if it purchased heavy machinery to engage in some construction work, would be so using capital.

The criteria for professional status which envolve from the Regulations clarify and add to the criteria evolved from the Law. First, there are eleven additional specifically named professions. Second, we obtain something of a working definition of a profession as a field of endeavor in which there is a need for science or learning which must be applied to the affairs of others. Third, we find standards for the tainting of professional status where businesses are operated by professional people. Fourth, we obtain standards for measuring capital as a material factor in the production of income.

Review of Court Decisions

We now come to a review of how courts have dealt with the interpretation of the Law and Regulations, and with the determinations of the Tax Commission.

The first group of cases for review involve brokers of one kind or another. The *Tower*[4] case, practically the father of the line, is one of the most frequently cited decisions in the field. A lawyer and two laymen formed a partnership to render service to the public as custom house brokers. Their function was to consult with clients concerning the nature and extent of import duties, and to minimize such duties. The taxpayers held a license issued by the Treasury Department to act as such brokers. Admission was made by the taxpayers that they could have incorporated, and that some of their competitors did function in corporate form. The Appellate Division held that the partnership was not practicing a profession for Unincorporated Business Tax purposes because the knowledge and skill required in taxpayer's business was not of that advanced type requiring a specialized course of instruction. Such requirement, in the court's opinion, is implicit in the term "professional." Secondly, the fact that taxpayer could operate as a corporation further removed it from the class of professional. The fact that the service performed was highly technical, and required considerable knowledge and skill, was not in itself sufficient to give it exempt status; nor did the fact that it was licensed prove to be of any help. The taxpayer was held subject to the tax.

In the *Robinson*[5] case we find, similarly, another situation of custom house brokers denied exempt status as professionals.

In two other cases, *Recht*[6] and *Otis*[7], we find that insurance brokers are unequivocally classified as business, and not professional.

Practitioners before the Interstate Commerce Commission were summarily disposed of as non-professional in the *Pollack*[8] and *Traub*[9] cases. In the *Traub* case the petitioner, who was a lawyer, obtained a license as a nonlawyer to practice as a Registered Interstate Commerce Practitioner. His function was to prepare and present, for clients, applications, petitions and briefs, and represent clients before the Commission. Petitioner presented evidence that he was a lawyer, although

[4] *Peo. ex rel. Duane L. Tower,* 257 App. Div. 1064; Aff'd, 282 N.Y. 407 (1940).

[5] *Peo. ex rel. Henry W. Robinson,* 259 App. Div. 956; leave to appeal denied, 284 N.Y. 821 (1940).

[6] *Matter of Rudolph Recht,* 257 App. Div. 889 (1940).

[7] *Matter of Cortlandt Otis,* 259 App. Div. 957 (1940).

[8] *Matter of Abner Pollack,* 266 App. Div. 699 (1943).

[9] *Matter of William D. Traub,* 286 App. Div. 927 (1955).

not practicing as such, and that he had taken courses in Interstate Commerce Law. The Court granted that courses in the field are given at university level, but emphasized that no degree is offered in the field. It therefore felt that the technical skill involved was not of the advanced nature to warrant classification as a profession.

The next group of cases for consideration was those few in which taxpayers successfully established professional status. The *Teague*[10] case is one of the rarities in which the erudition and training of the taxpayer were sufficient to induce the courts to give the stamp of professional approval. In this case the petitioner was an industrial designer who did not have a degree in the field, because at the time of his development, there were no such degrees given anywhere. However at the time this case developed, petitioner was lecturing and teaching at various universities which offered B.A. degrees in Industrial Design. He also wrote extensively, and was considered an authority in the field. The position taken by the Tax Commission was that since the petitioner had no degree in his field of practice, and since he held no license of any kind, he was engaged in business. The Court held that these arguments were invalid. It viewed as paradoxical that an individual, who was teaching the foundations of a profession to aspiring young professionals, should be held to be not professional himself, because he did not hold a degree for which he was preparing others. The Court went on to point out that the petitioner was practicing in a new field, which by dint of his own efforts had matured into acceptance as a profession for others who studied in the field. As to the fact that petitioner had no license, the Court pointed out that the licensing of liquor dealers and auctioneers did not make them professional, and failure of petitioner to be licensed could not make him less of a professional. The Court therefore held that petitioner was engaged in an exempt profession, and not subject to tax.

The *Geiffert*[11] case was another of the rare ones in which the petitioner was held to be a professional. In this case, as in the *Teague* case, petitioner was engaged in a newly developing field, namely that of landscape architect. Petitioner was a pioneer in the field. Here too, he had no degree as a landscape architect because none was given in the early days of his development. By this time, however, many universities were conferring degrees in landscape architecture. Petitioner collaborated on articles appearing in the Encyclopedia Brittannica and the Encyclopedia of Horticulture. The Appellate Division held that the petitioner was not a professional. The case was appealed, and the Court of Appeals reversed, and held that it was necessary that new professions be recognized in the law as well as in the universities. It should be noted that it took a bitterly contested lawsuit brought to the highest court in the State to finally give petitioner professional recognition. He was held exempt from tax.

Another case which was held not subject to tax, but had to reach the Court of Appeals to obtain such a determination, was the *Voorhees*[12] case. In this case, the famous orchestra conductor, Donald Voorhees, presented two radio programs, the "Cavalcade of America" and the "Telephone Hour." He hired and paid salaries to the musicians and arrangers, and paid the promotional and advertising expenses out of his funds. His principal function however was admittedly that of orchestra conductor. The Appellate Di-

[10] *Matter of Walter D. Teague,* 261 App. Div. 652; aff'd, 287, N.Y. 549 (1941).

[11] *Matter of Alfred Geiffert, Jr.,* 267 App. Div. 681; reversed, 293 N.Y. 583 (1944).

[12] *Matter of Donald D. Voorhees,* 282 App. Div. 988; reversed, 308 N.Y. 184 (1953).

vision held that he was in the business of selling two radio programs involving many elements beyond his conducting function, and he was therefore not in a profession. The Court of Appeals reversed the Appellate Division. It held that Voorhees had background and training of a most highly specialized kind; that his activities in the hiring of personnel and paying of expenses were for the convenience of his sponsors, and constituted a very small portion of his services; and that the services which he could and did perform that were of real value were those connected with his musical conducting. Voorhees was held to be engaged in a profession and exempt from tax.

All three of these cases, in which the taxpayer was held exempt, namely *Teague*, *Geiffert* and *Voorhees*, went to the highest court of the State before the exempt status was determined.

We then find a long line of cases of greater and lesser weight relying on the *Teague* and *Geiffert* cases, all unsuccessful in establishing professional status. It should be noted that some of these went to the Court of Appeals, and were denied exemption on some very strong facts in their favor. Of those that did not go up on appeal, it is difficult to predict what the outcome might have been had taxpayers been more tenacious in their lawsuits.

For example, the *DeVries*[13] case involved a furniture designer who studied designing, architectural designing, sculpture, and other fields of art and design. The Appellate Division held that he was engaged in a business not a profession. It relied, for its opinion, partly on the fact that petitioner was paid for his designs, by furniture dealers, on the basis of a percentage of their sales of his designs. Furthermore, it relied on the fact that his consultations with them, on the kinds of woods and finishes to be used, was indicative of business status. The case went to the Court of Appeals where the lower court was upheld, and petitioner was held taxable. However, a very strong and cogent dissenting opinion was written, which pointed out that petitioner was a highly trained and developed artist of admittedly high caliber. His work was principally designing, and his consultations as to manufacture were incidental to the best development of his designs. The opinion further pointed out that his being paid on a percentage of sales basis was no different from the situation of a writer who is paid a royalty on the number of books sold. The opinion concluded that taxpayer should be deemed professional. However, dissenting opinions do not make law, and they give little solace to the taxpayer under fire. The taxpayer was held subject to tax.

In the *Schmidt*[14] case, petitioner was a textile technologist who received a diploma after three years at the Philadelphia Textile Institute. He did advisory and consulting work for various textile firms. The Court held that there were some points of resemblance to the *Teague* and *Geiffert* cases, but not sufficient to extend professional exemption.

The *Englehardt*[15] case dealt with a firm of educational plant engineers, whose function it was to advise as to the planning of school buildings. The Court held that the petitioners were not professional because, while some universities offer semester courses in the field of plant engineering, none gives a degree so named.

In the *Backman* case, the petitioner was an economist who functioned as a consulting economist to many business firms. He was a professor of economics at New York University. He

[13] *Matter of Herman DeVries*, 266 App. Div. 1030; aff'd, 292 N.Y. 529 (1943).

[14] *Matter of Milton Schmidt*, 282 App. Div. 980 (1953).

[15] *Matter of Nicholaus L. Engelhardt*, 281 App. Div. 1053 (1952).

held the degrees of Bachelor of Commercial Science, Master of Business Administration, Master of Arts, and Doctor of Commercial Science. He wrote and lectured extensively in the field of Economics. The Court held that his consulting activities were carried on as a business and not as a profession. The decision can only make one marvel at the intellectual erudition inherent in business practice.

In the *Hewitt*[16] case, petitioners, a partnership, ran a private day school where they taught and supervised other teachers and administrative assistants. They claimed exemption on the ground that eighty per cent of the income was derived from the services of the partners, and that the services of their employee teachers and assistants should be ascribed to the partners. No one apparently claimed that teaching was not a profession. However the Court held that the services of employed teachers cannot be ascribed to their employers because the teaching services performed are independent of the kind of direction and supervision intended by the Tax Commission Regulations[1]. The Appellate Division held the school to be an unincorporated business and subject to tax. The Court of Appeals upheld the decision.

Another puzzling case is the one of *Strayer*[17]. Here petitioner was a practicing chiropractor who was held to be subject to tax. The State of New York does not license chiropractors, and the Court made its determination apparently on this basis. There is no question that degrees are given in the field, that petitioner had such a degree, that in many States, chiropractic is a licensed profession. The Court contends that until the Education Department grants licenses to chiropractors the Tax Department cannot acknowledge them as professionals.

Neither the *Schmidt,* nor the *Engelhardt,* nor the *Strayer* cases went beyond the Appellate Division. All were strong cases, where the petitioners were well-trained people practicing in fields which, in future years, will more likely than not be unequivocably accepted as professions. What the Court of Appeals might have done about them is anybody's guess. The *DeVries, Hewitt* and *Backman* cases went to the Court of Appeals, and despite the seemingly bad law they make, law it is, nonetheless.

We then come to a group of cases dealing with trained technicians, but all of them somewhat short of persuasion of professional status for one reason or another.

The *Seidman*[18] case, for example, was one in which the petitioners were textile brokers and consultants. Their function was to develop new textile fabrics and work out technical problems relating thereto for mills and converters. The Court held that petitioners could just as well have functioned as a corporation, and were subject to tax.

In the *Blaikie*[19] case, petitioner was a restaurant and food engineer, expert in restaurant equipment, operation and management. His knowledge was not deemed by the Court to be such as to make him a professional. He was held subject to tax.

In the *Pennicke*[20] case, petitioner who was an industrial consultant, was held subject to tax. His services involved the improvement of methods of office management and executive control. He was neither an engineer nor an architect. The Court held him to be non-professional.

A number of cases of seemingly still lesser merit fall into the same pattern

[16] *Matter of Caroline D. Hewitt,* 272 App. Div. 1; aff'd, 297 N.Y. 239 (1947).
[17] *Matter of Kenneth S. Strayer,* 285 App. Div. 739 (1955).
[18] *Peo. ex rel. George I. Seidman et al.,* 260 App. Div. 898 (1941).
[19] *Peo. ex rel. Ralph L. Blaikie,* 267 App. Div. 923 (1944).
[20] *Matter of Harold C. Pennicke,* 266 App. Div. 888 (1943).
[21] *Matter of Frederick A. Dewey,* 269 App. Div. 887 (1945).

of being held taxable. The *Dewey*[21] case involved an investment consultant; the *Cherington*[22] case dealt with marketing consultants; the *Wittick*[23] case was one of a sales promoter; the *Moffett*[24] case concerned itself with a consultant in corporate finance; the *Adelsberg*[25] case revolved about a valuation expert. In all of these situations, the activities could have been conducted in corporate form.

Summary

From a review of the cases we can set up a further group of criteria, unfortunately not always consistent, but of some general value in arriving at our own appraisals of subjectivity to tax. A degree should be given in the field, and the taxpayer should hold such a degree. A license should be given in the field, but need not be held by taxpayer, and sometimes when given proves of no significance. The taxpayer should have knowledge of an advanced type in a given field, gained by a prolonged course of specialized instruction. The taxpayer organization should not be susceptible of corporate form. Most important of all, determination should be sought in a Court that has a psychological affinity for the particular profession under fire.

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[22] *Matter of Paul T. Cherington*, 269 App. Div. 888 (1945).

[23] *Peo. ex rel. Val. R. Wittick, Jr.*, 270 App. Div. 774; aff'd, 269 N.Y. 720 (1946).

[24] *Peo. ex rel. John K. Moffett*, 276 App. Div. 38; aff'd, 301 N.Y. 597; cert. den., 340 U.S. 865 (1949).

[25] *Matter of Hyman Adelsberg*, 278 App. Div. 606 (1951).

Franchise Tax Returns for Business Corporations

By H. J. CONNORS

This paper points up the importance of fully and properly completing the New York franchise tax reports. It also discusses some problems of allocation and reclassification.

NOBODY likes taxes, so I suppose it is not easy to develop an affection for people like me who are responsible for collecting taxes. On the other hand, we in the Tax Department have found it easy to develop a liking and respect for you people in the accounting profession. Your knowledge and spirit of cooperation have immeasurably simplified our job of administering the Tax Law. That is why I was so pleased to receive the invitation to talk with you today. Discussions such as this are just as valuable to us as we hope they are to you.

Your chairman indicated that you would like me to cover those problems which may exist between the Department and the practitioner in order to arrive at a better understanding. He also suggested some comments on allocation and reclassification.

I do not need to remind you that the tax statutes dictate the course of nearly every operation and that our first duty is to carry out their intent as we see it and as the courts define it. But within this framework there must always be a place for principles of fair play and justice and for full regard for the rights of the taxpayer. While the State tax administrator has the responsibility always to protect the interests of the State government, he is no less obligated to help preserve the rights of the taxpayer.

The interests of the government and of the taxpayer are parallel and can best be served when there is mutual understanding between the State, the taxpayer, and you, as the representative of the taxpayer.

H. J. CONNORS is Deputy Tax Commissioner and Director of the Corporation Tax Bureau, Department of Taxation and Finance, State of New York. This paper was presented by Mr. Connors at a Society meeting held in Mount Vernon, N. Y., on February 9, 1956.

Importance of Fully Completed Tax Reports

You can be of enormous help to us if you will see to it that proper and complete franchise tax reports are filed with the Department. In the processing of so many thousand reports, you can appreciate that in the auditing procedure, difficulties inevitably arise where the reporting taxpayer has failed to answer some of the questions on the form. Naturally, this leads to time-consuming correspondence which might have been avoided, and is a source of irritation to both the Department and the taxpayer.

Frequently the taxpayer's reply to a letter from this office is: "That item was left blank because there was nothing to insert." We approach our job with the conviction that by far the greatest number of our taxpayers are honest. However, experience has indicated that where through error, an item has been left blank, the proper answer is not necessarily "no" or "none." If the proper answer is "no" or "none", and if the taxpayer would simply indicate "no" or "none" in the spaces provided, a great deal of corre-

spondence could be avoided to the advantage of all parties concerned.

I cannot emphasize too strongly the necessity for completing all of the forms as furnished by the Department. Please don't attach separate schedules as a substitute for answers required on the form. Separate schedules are acceptable only where necessary to amplify the answers to questions on the form. The many thousands of reports which are filed annually are audited by a very small force of examiners. As you can readily understand, the auditing of these reports is expedited to a tremendous degree when they are all prepared in a uniform manner. And incidentally, we have found that in many cases the use of separate schedules has reacted to the disadvantage of the taxpayer. As a result of not using the form provided, a taxpayer frequently fails to take advantage of the deduction of its income from subsidiaries or of 50% of its dividends from non-subsidiary corporations. As you can appreciate, such errors are more difficult for our examiners to detect when the proper form is not used. Believe it or not, we are as happy to make refunds when the taxpayer has overpaid its tax as we are to ask for additional taxes when it has underpaid. Seriously, I mean that. We're human beings, the same as you, and it always gives us considerable pleasure to notify a taxpayer it has a refund coming. But we can't do it if you don't give us the necessary information.

Make-up of Tax Report Form 3 CT

It might be well at this point to mention briefly the make-up of the report form. One of the questions that might come to your mind is how the reports to be filed this year by Article 9-A taxpayers compare with the reports for previous years and with the Federal reports. There has been no substantial change in Page 1 of the report. The first 30 items are exactly the same as on the Federal tax return. Items 31 to 43 should be used to make the adjustments to Federal net income as outlined in the regulations. Schedule D on the franchise tax report has been revised to conform with the revised Schedule M on the Federal return. As you know, Federal net income is the starting point in the computation of entire net income for New York State franchise tax purposes. In view of this, it is readily apparent that Schedule D on Page 2 of the report, which is the reconciliation of income and surplus on the Federal return, must be properly completed on your New York franchise tax report. Without Schedule D, we cannot verify that entire net income on your New York State franchise tax report has been based on Federal net income.

Now, let's go back for a moment to the Officers' schedule. As you probably have noted, commencing with the reports filed in 1954, we have included on the form provisions and instructions for computing the alternative tax, taking into consideration both officers' salaries and net income. The Department feels, and I believe you will agree, that there is no longer any reason for failing to use this method where it is applicable and to make the remittance accordingly.

Before we leave Form 3 CT, I'd like to discuss the reporting of federal changes in net income. There is provision for reporting such changes in Schedule H on Page 3. Where there are changes, we require the filing of a certified or photostatic copy of the schedules labelled "Adjustments to Net Income" and "Explanation of Items" from the Federal Revenue Agent's report.

Please don't send the original Revenue Agent's report and request that it be returned. Obviously, if we return the original Revenue Agent's report, we have no permanent record in our files as to the basis for the corrected tax.

When the change by the Revenue

Agent results in a reduction in net income for Federal purposes, we also require a certified or photostatic copy of the Certificate of Overassessment or Notice of Adjustment issued by the Treasury Department. This certificate is essential before a reduction of franchise tax can be approved. For your information, this Certificate can be identified by Federal form numbers 7776 or 1331.

Allocation Problems—Business Income and Capital

Now for a few minutes let's touch on some of the problems that arise in connection with allocation. It would be stretching the truth to leave you with the impression that we have no problems in this field.

In the first place, *any* corporation is entitled to allocate its investment income and capital and its subsidiary capital outside New York. It is not necessary to have a place of business outside New York to claim such an allocation. I shall therefore confine my discussion to the allocation of business income and capital.

Not every corporation taxable under Article 9-A is entitled to a business allocation. The statute provides that the business allocation will be 100% *unless* it can be shown that the corporation has either a "regular" or a "permanent or continuous" place of business outside the State.

If it has a regular or permanent and continuous place of business outside New York, then business income and business capital are allocated by a business allocation percentage using the so-called "Massachusetts formula" which is used in a number of other states. It is a three-factor formula using property, receipts, and payrolls. The percentage of each factor is determined and the total of the three percentages is divided by three to find the business percentage to be applied to business income and business capital.

The Property Factor

There is very little difficulty in determining the property factor. It includes all real and tangible personal property owned by the taxpayer, as well as all real property rented by the taxpayer from others. Such property is allocated to the place where it is located. The fair market value of real property which is rented by the taxpayer from others is determined by multiplying the rent payable during the year by eight. Rent is defined to include not only the actual rent paid, but also amounts paid by the taxpayer in lieu of rent. A common error made by taxpayers in computing the property factor is the use of year-end values instead of average values. This problem could be eliminated if taxpayers would complete column (d) of the balance sheet properly to show the average value of their assets. The values used in the property factor must be consistent with the values used in column (d) of the balance sheet.

The Payroll Factor

Likewise, we find that taxpayers have very little difficulty in determining the payroll factor. As you know, there should be included in the payroll factor *only* compensation paid to the taxpayer's own employees. Therefore, the payroll factor may not include the compensation of persons paid by another corporation even if the taxpayer has reimbursed this other corporation for services performed on its behalf. The compensation of general executive officers must of course be excluded.

The Receipts Factor

The greatest number of problems with respect to allocation arise in connection with the allocation of receipts. At this point, it might be worthwhile to reemphasize the distinction between a "regular" and a "permanent or continuous" place of business, since this is so important with respect to the receipts allocation.

The Regulations define a "permanent or continuous" place of business as any bona fide office, factory, warehouse, or other space at which the taxpayer is doing business *in its own name* in a regular and systematic manner, and which is continuously maintained, occupied and used by the taxpayer in carrying on its business *through its regular employees regularly in attendance.*

Now, let's take the case of a corporation whose only activity outside New York State consists of storing merchandise in a public warehouse from which deliveries are made to its customers. The public warehouse is not a permanent or continuous place of business as defined in the Regulations, but it is a "regular" place of business. The law therefore permits this taxpayer to allocate its property within and without New York on the basis of where such property is located. However, the receipts from the sale of the property in the warehouse must be allocated to New York. Permit me to cite another illustration of problems that arise with so-called convertors—corporations which are located in New York and which purchase greige goods for shipment to independent finishing mills principally located in the South. The greige goods remain at the plant of the independent contractor until the taxpayer issues instructions to the independent contractor to print the goods and ship the finished product to the taxpayer's customer. In such cases, we permit the taxpayer to allocate, outside New York, the greige goods located at the independent contractor's plant outside New York, but we insist on the allocation of all of the receipts to New York because the goods are not located at a permanent or continuous place of business *of the taxpayer* outside New York at the time of appropriation to the order.

Let's assume that in the example mentioned above, the taxpayer has some employees of its own on the premises of the contractor—to supervise processing or shipping of the goods. Many taxpayers are under the impression that the mere presence of their employees on the premises of the independent contractor makes such premises a permanent or continuous place of business of the taxpayer. That is just not so. As I said before, a permanent or continuous place of business outside New York is a place of business where the corporation is doing business in its own name, in a regular and systematic manner, as that term is generally understood. In the last analysis, the use of common sense will tell a taxpayer whether the place of business under consideration is his own or that of another.

Real Estate Corporations Taxable under Section 182

While we could continue discussing Article 9-A at much greater length, this is of course only one part of the tax structure administered by the Corporation Tax Bureau. In the limited time available, it might be worthwhile to touch on the question of real estate corporations taxable under Section 182 of Article 9, since the greatest number of corporations not taxable under Article 9-A fall within this category. The conditions under which a corporation becomes exempt from taxation under Article 9-A and becomes subject to tax under Section 182 are clearly defined by the statute. Since these conditions are extremely limited, you can see that most of our problems arise in connection with the activities which prevent a corporation from being subject to tax under Section 182.

The law provides that in order to be taxable under Section 182, a corporation must be *wholly engaged* in certain activities. It is the interpretation of the Tax Commission that the term *"wholly engaged"* must be construed literally, and that any deviation, no matter how slight, from the activities permitted prevents a corpo-

ration from being taxable under Section 182.

As you know, the law defines real estate corporations, for the purposes of Section 182, as those wholly engaged in:

1. The purchase and sale of, and holding title to, real estate for itself;
2. subleasing real property held under a leasehold for a term of 20 years or more, by the terms of which the taxes on the real property are paid by the lessee corporations;
3. holding title to bonds, notes or other obligations of the purchaser received upon the sale of any such real estate or any such leasehold and secured thereby.

To permit real estate corporations a certain amount of latitude in their ordinary operations, the statute provides that a corporation will not lose its classification under Section 182 if not more than 10% of its average gross assets, at full value, consists of stocks, bonds, or other securities, or loans to wholly owned subsidiaries taxable under Section 182.

In connection with this provision, we frequently encounter a taxpayer who believes it is remaining within the scope of Section 182 when it loans money to a wholly-owned subsidiary which is exclusively engaged in real estate activities outside of New York. Such a loan in any amount causes reclassification to Article 9-A if the subsidiary is not a taxpayer under Section 182. It is clear that the statute permits loans only to wholly-owned subsidiaries taxable under Section 182, and then subject to the 10% provision.

The statute further provides that a corporation will not lose its classification under Section 182 if it holds or acquires the entire capital stock of one or more corporations taxable under Section 182. The effect of this exemption is to exclude the value of such stock from the 10% limitation.

The statute finally provides that a Section 182 corporation will not lose its classification if it holds United States securities purchased on or after January 1, 1941, and owned on December 31, 1946. This section is so clear that no further comment appears necessary.

It should be obvious that engaging in any activities other than those I have just outlined will cause a corporation to lose its Section 182 classification. Examples of such activities are (1) renting furnished apartments or personal property of any kind; (2) acting as a broker or management agents for others; (3) holding property under a leasehold of less than 20 years; and of course, making loans of any amount other than those of the type I have already mentioned.

There may be other activities which would subject a corporation to reclassification to Article 9-A, but the examples I have mentioned will serve as a guide.

I know that in the limited time available I have not been able to cover all the questions you may have in your mind regarding the administration of the Tax Law. I hope that what I have said will be of some help to you in your relations with the Department. Any time that you wish to come to Albany to discuss specific tax problems of your clients, we will make every effort to arrange the time for such a conference to suit your convenience—and we will be more than happy to see you. It has been a real pleasure for me to be here, and I want to thank you for your very kind attention.

Codification of Statements on Auditing Procedure

The Board of Directors of the Society feels that the growing acceptance by the profession throughout the country of the pronouncements of the Committee on Auditing Procedure of the American Institute of Accountants, makes it a matter of great importance that all members of the Society be fully informed with respect to them. Accordingly, it has been decided to publish, in serial form, in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT, *the two principal Institute publications in which they are set forth, namely, "Generally Accepted Auditing Standards, Their Significance and Scope", and "Codification of Statements on Auditing Procedure". The following reprint is the third in the series dealing with the "Codification".*

II—CONFIRMATION OF PUBLIC UTILITY ACCOUNTS RECEIVABLE

Query: The XYZ Corporation is a utility with a satisfactory system of internal control and has approximately 50,000 residential, commercial, rural, industrial, and other customers. Is it practicable and reasonable to communicate directly with these customers as a matter of regular procedure in the examination of the company's financial statements, and if so, how extensive should the confirmation be?

The total receivables of utilities usually average two per cent of all assets and about ten per cent of annual revenues. Accumulations of receivables materially beyond these percentages result from unusual conditions and would evoke inquiry, apart from the question of confirmation. The average account balance for all accounts receivable of utilities seldom averages more than $10 a customer.

It is desirable to discuss the receivables under two general categories, namely:

A. The large accounts—municipal, other utilities, industrial, and miscellaneous.

B. The "mass" accounts—residential, commercial, rural, and merchandise.

Experience indicates that on the average a little less than half the total electric utility receivables is represented by the first group consisting of industrial and other large accounts, and that for utilities other than electric the proportion is usually smaller.

It is recognized that in many utilities these two categories are not carried in separate general ledger control accounts. However, most utilities maintain sufficient subdivisions in the detail records to permit such a classification.

A. The Large Accounts—Municipal, Other Utilities, Industrial, and Miscellaneous

The large accounts are carried with organizations which maintain adequate records and accordingly are in a position to express an informed opinion on

the correctness of charges made against them. The methods of computation for service rendered to these customers [page 41*] are often very technical, complicated, and difficult to test-check. While internal control is important and must be considered, it cannot be relied upon as greatly by the independent auditor to serve his purposes as in the case of "mass" accounts discussed later. Furthermore, because of the size of individual accounts it is possible for irregularities, if any exist, to be confined to relatively few accounts. Accordingly, the extent of confirmation of these receivables should be similar to that of the accounts of an industrial enterprise where comparable conditions prevail.

B. The "Mass" Accounts—Residential, Commercial, Rural and Merchandise

Many factors distinguish this class of accounts from those of the first group. The average number of "mass" accounts of a utility is very large in relation to the gross revenues and varies from a few thousand in a small utility to hundreds of thousands in the larger organizations. Individual balances average a few dollars each; even including merchandise instalment accounts, an average of under $10 a customer is ordinary. Because utilities follow the policy of disconnecting service if the "mass" accounts are not promptly paid and in many cases grant more than ordinary discounts for prompt payment, the total amount of service receivables not derived from the current month's billings is generally not significant.

The characteristics of these accounts create a large volume of small and simple repetitive operations which require special skill and efficiency for economical performance. As a result these operations are ordinarily assigned to separate employees or departments which operate independently of one another. In the particular case under consideration it was found that the more important separation of duties among employees and departments is as follows:

1. Installation and removal of meters or stations
2. Meter reading
3. Billing and maintenance of receivable ledgers
4. Receiving payment on accounts
5. Investigation and collection of delinquent accounts

In addition to the above segregation of major duties among independent departments or employees, further secondary checks are employed, such as rotation of meter readers among routes, checking of new accounts against those previously written off, maintenance of control accounts by employees other than those assigned to detail accounts, requirements that vacations be taken by cashiers, and approval of discounts forfeited.

[page 42] These segregations of duties among disassociated employees create an internal control which prevents any particular employee from controlling a sufficient number of the operations to conceal material irregularities, and assures essential accuracy and the absence of any but minor irregularities. In reviewing such systems, the presence or absence of a particular feature of the system should not be stressed unduly unless it is likely to be the source of a

* This reference, and those which follow in the same form, are to the paging in the official edition of this publication. This will facilitate the use of the cross-references appearing in the original document.

fundamental weakness. It is the effectiveness of the system as a whole which is important in justifying reliance upon the accounts.

Where applicable, controls essentially comparable with the foregoing are also maintained over merchandise receivables. The company collects merchandise instalments as part of its monthly bill for service and, in addition to disconnecting service if the monthly bill is not paid, follows the practice of repossessing the merchandise after an instalment is thirty days overdue. The amount of overdue accounts is consequently negligible.

Experience gained from review and test checks of systems of internal control, such as the one described, indicates that the "mass" accounts receivable balances maintained by most utilities are reliable for financial statement purposes, and that where the system in operation is good, test confirmation for the purpose of checking the credibility of the company's representations as to their authenticity is not necessary.

Where the conclusion reached in a specific case is that the system in operation is good, experience has nevertheless indicated the desirability of making a small sample circularization as an additional check upon the functioning of the internal control. In the case of the XYZ Corporation, which has a satisfactory system of control and approximately 50,000 "mass" accounts receivable with customers, approximately half with unpaid balances, it is believed that confirmation of a few hundred accounts will be adequate for this purpose. It is also believed that, in view of the purpose of the test, which is to provide an additional check upon the functioning of the internal control, such a test confirmation is desirable even when test confirmations are made by the utility's internal auditors.

Division of duties comprising internal control will vary among utilities according to type of utility and concentration of activities. It should be borne in mind that where a satisfactory system of internal control does not exist, a larger portion of the accounts should be confirmed, the extent being dependent upon the circumstances of the particular situation.

III—REFERENCES TO THE INDEPENDENT PUBLIC ACCOUNTANT IN SECURITIES REGISTRATIONS

[page 43] In defining its concept of the independent public accountant's responsibility the Securities and Exchange Commission has clearly indicated that it concurs in the Institute's view that the registrant is primarily responsible for the financial representations; that the independent public accountant's responsibility is limited to an expression of his professional opinion; and that he cannot properly undertake to express such an opinion except on the basis of an adequate examination conducted with professional skill and acumen.

In its statement* accompanying Amendment 3 to Regulation S-X the Commission discusses in detail its requirements respecting the independent public accountant's opinion. Rule 2-02 of Regulation S-X now provides:

"(a) Technical requirements

"The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

* SEC Accounting Series Release No. 21.

"(b) Representations as to the audit

"The accountant's certificate (i) shall state whether the audit was made in accordance with generally accepted auditing standards; and (ii) shall designate any auditing procedures generally recognized as normal, or deemed necessary by the accountant under the circumstances of a particular case, which have been omitted, and the reasons for their omission.

"Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

"(c) Opinions to be expressed

"The accountant's certificate shall state clearly:

"(i) The opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein;

"(ii) The opinion of the accountant as to any material changes in accounting principles or practices, or method of applying the accounting principles or practices, or adjustments of the accounts, required to be set forth by rule 3-07; and

"(iii) The nature of, and the opinion of the accountant as to, [page 44] any material differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

"(d) Exceptions

"Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given."

It is important that language used in registration statements and prospectuses to identify financial representations presented therein should avoid imputing to the independent certified public accountant responsibility greater than that contemplated by the Act or intended to be assumed by him. When financial statements are thus referred to by the registrant, language comparable to the following should be used:

"The following financial statements and schedules have been examined by ————————, independent certified public accountants, whose report with respect thereto appears on the following page."

This statement may be supplemented, if desired, by a phrase "and such financial statements and schedules have been made a part of this registration statement in reliance upon the report of such firm as experts" or "and such financial statements and schedules have been made a part of this registration statement with the authority of the report of such firm as experts." The purpose is to state that the accountant in his capacity as an independent expert has examined the financial statements, which are, however, the representations of

the registrant, and to direct attention to the opinion of the accountant, which should be read in conjunction with those representations. The language used should avoid such phrases as "has been prepared by————, independent certified public accountants," or "are stated on the authority of such firm as experts."

Earnings Summaries, Etc.

Earnings summaries, sales and earnings tables, historical financial information, etc., as included in registration statements and prospectuses are, for the most part, extracts or summaries of information contained in financial statements included therein, or in previous reports issued by the company.

In Accounting Series Release No. 62 the chief accountant of the [page 45] Commission comments as follows on the independent public accountant's responsibility for summary earnings tables:

"Summary earnings tables included in registration statements are not required by the Commission's rules to be certified by independent public or independent certified public accountants. It is, nevertheless, common practice introduce the summary with language indicating that it has been 'reviewed' by independent accountants.

"This use of an accountant's name in connection with a summary earnings table is designed and tends to give added authority to the material presented. It is important, therefore, to consider the extent of the examination to be made by the accountant in such cases and the extent of the responsibility which he as an expert accountant can properly assume . . . .

"Clearly, the mere summarization of detailed financial data prepared or presented by others does not involve most of the fundamental accounting and auditing skills customarily and properly relied upon as giving additional weight to financial statements certified by independent public accountants and adds nothing to the reliability of the underlying information.

"In view of the foregoing it is my opinion that it is generally improper and misleading for an accountant to permit his name to be used in connection with any period covered by a summary earnings table or to undertake to express his professional opinion as to the fairness of the representations made for such period in a summary earnings table unless he has made an examination for such period in accordance with generally accepted auditing standards applicable in the circumstances. When the independent accountant has been the auditor for the company throughout the entire period covered by the summary, and his several examinations conformed to generally accepted auditing standards, he would ordinarily need to make only such additional review as would be necessary to satisfy himself as to whether any recasting of the statements originally prepared would be necessary to reflect transactions and adjustments recorded in later years but clearly applicable to prior operations. If the instant work represents the first engagement of the accountant by the registrant and he is to express his expert opinion with respect to the earlier periods contained in the summary, it would, in my opinion, be necessary for him to apply to the operations and transactions of each of the earlier periods with respect to which he is to express an opinion substantially the same auditing procedures as those employed with respect to the first two years of the three-year certified [page 46]

profit and loss or income statement included in the registration statement.[11]

"In cases where the accountant has performed sufficient work to make it appropriate for him to permit the use of his name in connection with a summary earnings table there remains to be considered the form in which he should indicate his opinion. Under the rules promulgated by this Commission, the customary method used by accountants in expressing their expert opinion takes the form of a certificate conforming to the requirements of Rule 2-02 of Regulation S-X. Such certificates make appropriate representations as to the work done, state the opinion of the accountants as to the fairness of the statements presented, and describe clearly any exceptions which the accountants may wish to take. Since, as pointed out earlier, summary earnings tables are a species of income statement it would appear that the accountant's certificate thereon should assume a comparable form, and should be included with the summary or made a part of his report as to the three-year certified statement. If exceptions have been taken by the accountant with respect to any of the information contained in the summary earnings table, special care should be exercised in selecting the language used to introduce the summary to indicate clearly that such exceptions exist and to direct attention to the opinion of the accountant."

From the foregoing it appears that the independent certified public accountant should not permit reference to his name as giving weight to any part of a summary earnings table included in a registration statement or prospectus as to which he has not performed such auditing procedures as would justify his expressing an opinion; and that his opinion as to years not covered by the financial statements included in the registration statement, where expressed, may take the form of a separate certificate included with the summary or be included in the certificate relating to the financial statements.

In referring to summaries of earnings, statements such as the following may be used:

1. "The following summary of earnings, except for the unaudited data for the ———— months ended ————, has been examined by ————, independent certified public accountants, whose opinion with respect thereto is contained elsewhere herein. The figures [page 47] for the ———— years ended ———— should be read in conjunction with the financial statements contained elsewhere in this prospectus."

2. "This summary of earnings is based, as to the three years ended ————, upon income statements appearing elsewhere herein, and as to the two years ended ————, upon income statements included in the company's annual reports to stockholders. The earnings figures for the ——— months ended ———— have been compiled from the books of the company (amended as indicated in Note ————) and have not been reviewed by independent certified public accountants. The summary should be considered in conjunction with its footnotes and Notes to Financial Statements appearing elsewhere herein, and, as to the five years ended ————, is covered by the certificate

[11] It is recognized that some auditing procedures commonly applicable in the examination of financial statements for the latest year for which a certified profit and loss statement is filed, such as the independent confirmation of accounts receivable or the observation of inventory-taking, are either impracticable or impossible to perform with respect to the financial statements of the earlier years and, hence, would not be considered applicable in the circumstances."

of ————, independent certified public accountants, contained elsewhere in this prospectus."

3. "This summary has been prepared from financial statements included in annual reports to stockholders, as examined by ————, independent certified public accountants, and is presented herein in reliance upon the reports of said firm as experts. The figures shown for the three years ended ———— should be considered in conjunction with the more detailed information contained in the financial statements, with notes thereon, and with the report of ———— included elsewhere in this prospectus."

4. "The following summary of earnings has been prepared from financial statements previously examined by ————, independent certified public accountants, with respect to the eight years ended ————, and from financial statements included herein as a part of this prospectus with respect to the three years ended ————. The information for the three years ended ———— should be considered in the light of the financial statements and related notes in this prospectus. The summary of earnings for the eleven years ended ———— has been reviewed by ———— for the company and is included herein in reliance upon the report of such firm as experts in making such review. The figures for the ———— months ended ———— have been compiled by the company from its records."

Such language directs attention to the fact that, in so far as the data have been prepared from financial statements examined by the independent certified public accountant, they should be used and interpreted in conjunction with the complete financial statements and his opinion thereon as reflected in his reports related thereto or contained elsewhere in the prospectus. Language which suggests that the summary "has been prepared by ————, independent certi-
[page 48] fied public accountants," or is given "on their authority as experts" should not be used, since it may, when linked with or specifically referred to in his consent to the use of his name, be interpreted as meaning that the accountant has responsibilities respecting the representations made other than those contemplated by the Act or than he intends to assume.

Whenever the independent certified public accountant consents to the use of his name in reference to summaries of earnings, other summaries, or historical financial information, he should take the responsibility for a fair summarization or presentation. In certain circumstances this may involve more than a cross reference to the detailed statements. The basic objective is, of course, that the summary should be so constructed that there will be no materially different interpretation thereof from that obtained in the consideration of the detailed statements. In any case where the independent certified public accountant's name is used in reference to summaries of earnings for prior years not included in the registration statement, he should review the results for those years to determine whether the information previously published requires change due to substantial retroactive adjustments and whether explanatory footnotes may be necessary.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Change of Residence and Personal Exemption

An individual resides in New York until April 1, after which he becomes a bona fide resident of New Jersey. His entire income is derived from a salary that he earns in New Jersey. To what extent is he subject to tax by New York and to what personal exemption is he entitled?

While a resident in New York he was subject to tax on all of his income from all sources. Therefore he was subject to tax on his salary until April 1 even though it was earned outside the state. After April 1 he is subject to tax only on income earned in New York and, since he earned no income in New York, he is not subject to any tax in New York after April 1.

Where a taxpayer changes his status from that of a resident to a nonresident, or the reverse, two returns are required to be filed, one on Form 201 as a resident and the second on Form 203 as a nonresident. The Regulations (Art. 524) provide that for the period prior to the change the return for the period of residency must be on the accrual basis, even though the taxpayer ordinarily had been reporting on a cash basis. The purpose of this provision is to prevent a taxpayer from avoiding the tax on any income already accrued by reason of a change in residence.

It should also be noted that where two returns for one taxable year must be filed because of change in residential status, the tax may not be less than would be payable if total net income and net capital gain shown by the two returns were included in one return.

The Regulations (Art. 210) provide that the personal exemption in the event of a change of status must be apportioned and allocated to the respective returns, the allocation being made by months or the major portion of a month. Even though the taxpayer is not subject to any tax after he becomes a nonresident, only 3/12 of the personal exemption would be allowed on the resident return required to be filed.

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Mr. Harrow is a past Vice-President of the Society. He is a past Chairman of the Committee on Publications and of the Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Gross Receipts—Significance of Payment under Protest

A refund of tax paid may not be secured by a taxpayer if the tax paid is due to a mistake in law unless the taxpayer originally paid the tax under protest. Without protest a taxpayer may obtain a refund if the mistake is one of fact. We have discussed this provision in the law in prior issues of the Tax Forum[1]. A recent case[2]

[1] Vol. XXV, No. 4; April 1955, p. 244.

[2] *Bellefonte Dyeing Corp.* v. *Gerosa*, Supreme Court, Special Term, Part III, N.Y. County, N.Y.L.J., 1/17/56, p. 7.

brings the issue before the courts again, spurred on probably by the decision in *United Piece Dye Works* v. *Joseph* (307 N. Y. 780).

The Bellefonte Dyeing Corp. under that decision is not subject to the tax since it is engaged in interstate commerce. However that decision does not give the corporation a right to recover taxes for prior years where such taxes were not paid under protest. The corporation had argued that the payments were made under the mistaken impression that some of its receipts were subject to the business tax and for that reason were not made under protest. The court argued that no assessment was ever made or threatened by the city. No determination was made that any taxes were due and no procedure was taken to enforce payment. There was nothing to indicate a challenge to the law imposing the tax and the tax appeared to have been paid with full knowledge of all the facts. The payments were made voluntarily and without any evidence of coercion or duress.

Had there been any coercion or duress the court would probably have allowed the refund. That issue was before the court in another case.[3] In this case a foreign corporation sought to recover gross receipts taxes paid for the years 1948 to 1953, even though the taxes were not paid under protest. The corporation had made numerous informal protests in the first years in which the tax was assessed against it. It refrained from contesting the payment of tax due to the cost of litigation and the city's threat "that if payments were made under protest plaintiff would be subjected to audits, which if doubtful would be decided adversely to plaintiff and that the city would throw the book at the plaintiff and no penalties would be remitted." The payments were held to have been made under duress and the corporation was thus entitled to recover.

Charitable Deductions and the Net Operating Loss

In the March issue[4] of the State Tax Forum we discussed the 5% limitation under the Internal Revenue Code of the charitable deduction, and the effect of all this under the franchise tax law. We stated that the charitable deduction is not limited by a net operating loss carryback, but is limited by a net operating loss carryforward. One of our members finds no specific reference in the Code to a reduction of the charitable deduction by reason of an operating loss carryforward, but agrees that Section 170 of the Internal Revenue Code removes any reduction of the contribution because of a carryback. As he puts it, "Are we to assume that because the law is specific in allowing a contribution on a carryback, the absence of language removes this allowance on a carryforward?"

But there is no absence of language. A little interpretation will spell it out. The deduction for charitable contributions of a corporation is limited to 5% of *taxable income.* Taxable income is defined in Section 63 as gross income minus deductions and one of the enumerated deductions is the net operating loss deduction which in turn consists of the aggregate of net operating loss carryovers and net operating loss carrybacks. Now the Code [Section 170(b)] says that a net operating loss carryback does not require a recomputation of the maximum deduction for charitable contributions. This provision was put into the law for the reason that when a corporation files its tax return for any year, it cannot be aware of any operating loss carrybacks, since these do not arise until a year or two later. Congress apparently wanted to avoid a recomputation

[3] *U.S. Envelope Co.* v. *City of New York.*
[4] P. 190.

of the charitable deduction because of an operating loss that happened in a later year which under another provision of the law can be carried back to an earlier year. That situation of course is not present in the case of a carryover of an operating loss. When the corporation files a return for any year it is already aware of this carryover, and that carryover is a deduction from gross income in arriving at taxable income. The basis for the limitation on charitable contributions is taxable income.

Treatment of Insurance under the Estate Tax Law (Article 10c)

The law follows the federal rule. That means, first, that all proceeds of insurance received by the executor are includible in the gross estate. Secondly, the proceeds of insurance policies received by all other beneficiaries are includible to the same extent that they would be includible under the provisions of the Code in effect at the time of death. Thus, if a decedent died on or after August 17, 1954, (the date of enactment of the 1954 Code) such life insurance would be includible if the decedent possessed any incidents of ownership in the policies at the time of his death. The premium test is no longer applicable. The proceeds would also be includible if the decedent had a reversionary interest or possibility of reverter which actuarily exceeds 5% of the value of the policy at the date of death.

If the decedent died between September 23, 1950, and August 17, 1954, the insurance would be includible in the gross estate if the decedent directly or indirectly paid the premiums. A reversionary interest or possibility of reverter arising out of operation of law does not constitute an incident of ownership for such decedents.

Computation of Insurance Exemption

The estate tax is computed on the net estate which means the gross estate less all deductions including the marital deduction for transfers to a surviving spouse. The tax is a graduated tax, the first $150,000 of which is subject to a tax of 1%. There are two possible exemptions, a personal exemption and an exemption for insurance payable to named beneficiaries and both of them are deductible only from the first bracket of $150,000. The personal exemption may not exceed $20,000 of the amount transferred to and indefeasibly vested in a husband or wife. That exemption must be reduced by any marital deduction allowed because of the transfer to a surviving spouse. In addition an exemption up to $5,000 is allowed for transfers to certain members of the decedent's family. These are stated in the law [Section 249(q)(b)].

The other exemption is for insurance includible in the gross estate. If the surviving spouse was the beneficiary of the insurance policy the exemption would be the insurance proceeds up to a maximum of $100,000 reduced by the personal exemptions and any marital deduction. For example, assume a net estate of $300,000 and a marital deduction of $215,000, insurance payable to the widow of $50,000 and insurance payable to the children of $70,000 and bequests to three children totalling $50,000. The insurance exemption for the widow would be $100,000 less $15,000 (three exemptions of $5,000 for the children), less the marital deduction of $215,000. There would thus be no insurance exemption available for the proceeds left to the widow. It should be noted that because of the amount of the marital deduction no personal exemption is available for the surviving spouse.

With respect to the insurance payable to the children there would be an insurance exemption determined as follows: $100,000 less $15,000 (personal exemptions for the children) and less $20,000 (the lesser of the marital

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Accounting at the S. E. C.

Conducted by LOUIS H. RAPPAPORT, C.P.A.

MOST registration statements filed under the Securities Act of 1933 contain summaries of earnings. The summaries are usually certified for at least a period of three years. Frequently the summary also contains information for an interim period from the close of the most recent fiscal year to a recent date, and, in some cases, for the corresponding interim period of the preceding fiscal year. Thus, for example, if a registration statement were being filed today on Form S-1, the prospectus might contain certified financial statements to the end of calendar year 1955 and might be supplemented by unaudited interim figures for the three months ended March 31, 1956, and for the corresponding quarter of 1955.

This column has pointed out previously that the most recent interim figures need not be certified by independent certified public accountants. With respect to such unaudited figures, however, the registrant must represent that they include all adjustments necessary for a fair statement of the results for such periods. This requirement is a by-product of the *Kaiser-Frazer* case, to which reference has also been previously made in this column.

The requirement which causes the company to make the representation referred to in the preceding paragraph is now embodied in the instructions relating to summaries of earnings in Form S-1. The applicable instruction reads, in part, as follows:

> In connection with any unaudited summary for an interim period or periods between the end of the last fiscal year and the balance sheet date, and any comparable unaudited prior period, a statement shall be made that all adjustments necessary to a fair statement of the results for such interim period or periods, have been included.

In accordance with this requirement, some companies have made the following representation concerning unaudited interim figures included in earnings summaries:

> The summary of earnings for the (periods) ended (date) and (date) has been prepared from the records of the company without audit by independent certified public accountants, and, in the opinion of the company, reflects all adjustments necessary to present fairly the results of operations for the periods.

The foregoing representation has been found in practice to be acceptable to the SEC. Other companies have been unwilling to make as forceful a representation regarding unaudited figures. These companies took the position that they did not know of any adjustments of the unaudited figures that were necessary for a fair statement. Consequently their representations were phrased somewhat along these lines:

> The summary for the (periods) ended (date) and (date) has not been examined by independent certified public accountants; the company does not know of any adjustment necessary for a fair statement of the result for such periods.

The latter form of representation was used in a recent registration statement with which we are familiar. The SEC in its "letter of comment" criticized the form of the company's representation. The Commission maintained that the representation as to adjustments in the headnote to the earnings summary should be stated in the positive form as specified in the instructions of Form S-1. From inquiries we have made, we understand that SEC has made similar criticisms in other cases where the company's representation was stated negatively. It now appears that the negative form of representation is no longer acceptable, and that the Commission now insists that the instructions of Form S-1 be complied with literally.

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Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Staff Room Facilities and Efficiency

It has been stated that, to achieve maximum efficiency, a staff room should provide for no more than two to four staff members. Nevertheless, many staff rooms are much larger, some with a capacity of as many as twenty or more men. An oversized room permits excessive disturbance of the quiet needed for concentration as well as other abuses.

There are two pieces of equipment which can accomplish much in curbing the disturbances in an oversized staff room. Each constitutes a form of a partition that will cause little, if any, loss of light and ventilation.

First there is the low, movable type of partition, approximately four to five feet high, with the upper portion consisting of opaque glass. It can be utilized to create work areas, grouping two, three, or four desks, as desired. Being movable, it can be shifted about as necessary to vary the desk groupings. Though such partitioning is not as effective as separate rooms, it may be the next best device.

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The second piece of equipment is a desk which has a ledge or shelf attachment extending the length of the back of the desk. The shelf, made of metal, provides a wall about twenty inches high attached to the back of the desk and the top of the wall constitutes a shelf on which may be placed papers and folders which crowd a desk and are not immediately required for use. Thus two benefits are realized, the wall is discouraging of idle conversations with men seated at the desks in front of others, and the shelf enlarges the effective working area of the desk. In a crowded staff room, smaller-size shelf desks might help reduce the congestion. It is also possible to use the small side partitions as a further deterrent against unnecessary disturbances even where shelf desks are used.

If report reviewers and proofreaders are also located in a staff room, because of space inadequacies, their efficiency will be materially increased if they are "encased" by a low, glass wall partition. The partition need be only high enough to provide a psychological barrier against frivolous disturbances, yet permit easy movement to and from the desks of those protected by the partition. Some small amount of floor space may be lost in the partitioning but that will be more than offset by the increased efficiency of the personnel.

Automobile Use Allowances

This subject will probably provide grounds for grumbling, by practitioners as well as by staff members, perhaps forever. It is a situation that is always in a state of flux, just as are the accountants who daily travel to different locations to carry out their engagements.

The 'dollars and cents' aspect probably is not the most important one. What is often at issue is the principle of fair dealing. The questions that are commonly raised are such as these:

1. Should private car use on short trips be paid for in cases where less costly public transit facilities are available?

2. Should there be any difference between a short and long trip rate allowance?

3. What is a fair auto use allowance?

With respect to question No. 1, the answer is "no" unless a worthwhile time saving is involved, or extensive files must be transported, or if any other worthy reason is furnished. Car drivers, as a whole, have become so attached to their cars as to have developed an antipathy for other means of travel.

On out-of-town trips up to about 400 miles, automobile use may be very desirable because other forms of transit are often inadequate and poorly scheduled. Moreover, if several men join on the trip, there are several added benefits.

A difference in the rate of allowance on short and long trips can be justified in many instances. If a car is used only occasionally for business purposes, the mileage rate should not reflect all operating and maintenance costs. Certain costs are unaffected by the occasional trips, e.g., insurance, depreciation, license fee, etc. If a car is used frequently for business trips, all costs should be taken into account.

On a long trip the allowance might be either the equivalent of the rail or plane fare, or a mileage allowance at a rate that reflects all auto costs. On short trips a reduced rate per mile should be allowed where auto use is justifiable. Staff men will see the fairness of the differential if the matter is talked out with them.

The entire subject of auto use and rates should be talked out with a cross-section of the staff to insure that the policies adopted are considered fair by the staff. This will make for better acceptance and is an aid in morale maintenance. A hard policy will not result in a worthwhile economy but may result in time losses and dissatisfaction.

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deduction or the exemption for a spouse of $20,000). The maximum insurance exemption therefore could be $65,000 and that is the amount allowed in this case since the insurance proceeds for the children were $70,000. The exemption would have been further reduced by any insurance exemptions allowed for the surviving spouse.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Unemployment Insurance Legislation and New Rulings for 1956

Some Bills That Passed and Some That Failed

The New York State Legislature passed ten bills affecting unemployment insurance and failed to pass five others which the Governor recommended, one of which was of particular importance since it had a direct bearing on the coming increase in the New York contribution rate effective January 1, 1957.

Since all these measures have important tax consequences, they should be studied carefully by accountants before advising clients on unemployment insurance tax matters for the present and coming years. Bear in mind that while the Governor has not as yet signed the bills that passed, it is expected that he will give his approval to all of them. There is much in these measures that does not meet the eye in a quick reading by the "read and run" practitioner. Unless some of these tax provisions are clearly understood relative to tax rates, credits, exemptions, and various dates affecting taxes mentioned in the law, desired tax savings may not be achieved. The best advice the busy practitioner can follow is if you yourself don't know, ask the man who does.

SAMUEL S. RESS, an Associate Member of our Society since 1936, is a member of the New York and Massachusetts Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committee on New York State Taxation and Chairman of the Sub-Committee on Unemployment Insurance.

Qualified Employer Change Made For Experience Rating

This measure amends section 581.1(c) of the Unemployment Insurance Law by reducing the period of time within which an employer, newly covered by the law, can become eligible for a reduced rate because of favorable experience with unemployment insurance. During the present year, employers require a minimum of 14 consecutive calendar quarters of coverage in order to be eligible; the new law will enable employers with more than 4 quarters of consecutive coverage prior to July 1, 1956, to become eligible for experience rating on unemployment insurance taxes payable on payrolls on and after January 1, 1957.

Subsidiary Contributions Will Be Required in 1957

It appears fairly certain that commencing January 1, 1957, the section 577 "subsidiary contribution" will have to be paid because the State Legislature did not pass a proposal to ward off the imposition of this imminent additional assessment presently provided in the law. The contemplated additional tax will amount to .3 per cent of taxable wages, and it is estimated that the subsidiary contribution will cost the employers in this state between 35 and 40 million dollars next year, and a slightly larger amount during the following year. However, because the Legislature felt that newly covered employers should not be required to bear this imposi-

tion, a bill was passed which would exempt newly-covered employers, that is, employers with fewer than 5 quarters of coverage from this tax. Apparently this relief measure may well be labeled "inexperience rating", and it appears to offer a new quick tax saving device to employers with poor experience in unemployment insurance, and who desire to escape the imposition of the new subsidiary tax. It has been suggested that this could be accomplished by going out of business before the end of the current year, and commencing business as a new employer after the beginning of the coming year. Coupled with the measure that makes new employers eligible for experience rating after the passage of slightly more than one year, instead of the longer 3½ year period required under the law before the amendment discussed in the foregoing paragraph, a new loophole appears to have opened up. However, in line with the note of caution mentioned elsewhere in this column, all phases of the contemplated course of action should be carefully studied and if necessary, expert counsel consulted before proceeding.

Principal Stockholder Exemption from Remuneration Limited to Holders of 25 Per Cent or More of Voting Stock—Section 517.2 (d)

Under the law, remuneration does not include, and tax should not be paid on, compensation of principal stockholders of corporations not liable for Federal Unemployment Tax (employers of four or more employees for 20 days in each of 20 different calendar weeks of the calendar year are covered). The old law provided for allowance of the exemption in cases where 25% or more of the capital stock was held by the employee. The new provision grants the exemption to the stockholder-employee who has 25% or more of the voting stock issued and outstanding, regardless of the amount of capital stock sold and outstanding, preferred or common, par or no par.

Corrections and Modifications in Experience Rates—Section 581.6

Heretofore the Industrial Commissioner had 4 years after the effective date—December 31st of any year—within which to correct or modify any employer's experience rate, while the employer only had until the effective date; the amendment gives 2 years to both employer and State, regardless of whether the change would raise or lower his rate.

Experience Rating Notices Issued for Year 1956

The State has issued new contribution rate notices to each employer for the year 1956. Rates range from .5% to 2.7%, payable on covered payrolls. Members of the Society may address any questions with respect thereto to the Editor of this department.

Miscellaneous Bills Which Passed

The other bills which passed deal with various technical and administrative phases of the law, with the exception of one which provides for the elimination of the one-week waiting period in the event unemployment is the result of a catastrophe such as the floods and hurricane emergencies of last year. None of the measures to reduce the qualifying period for benefits from 20 to 15 weeks, nor the proposals to increase the benefit rate maximum to $40 plus additional benefits for dependents, etc., were passed. The bill extending coverage to employers of one or more failed of passage again. However, many employers of one or more continue covered until granted exemption from coverage, if they had been covered by the law during a period when they employed 4 or more for 15 days as the law provided prior to January 1, 1956, or 3 or more on any one day in 1956, or 2 or more on any one day on or after January 1, 1957, with the exception of household employees and certain other exempt categories.

No Legislative Relief Granted from Request Report Penalties

One such matter deals with the imposition of the Request Report Penalty. It was hoped that this session of the Legislature might have accepted the writer's suggestion that the imposition of the Request Report Penalty be made discretionary and not mandatory, as presently provided, so as to permit relief where none is presently available in cases deserving of equity relief where the law is harsh.

Liability For Unemployment Insurance Contributions on Compensation Paid to Musicians

In the *Matter of the Liability for Unemployment Insurance Contributions of Savoy Ballroom Corporation,* the Appellate Division decision contains a full discussion of the pertinent provisions of both the state and federal law and is set forth in full below. It is one of the most important court decisions in this field to have been handed down during recent months.

Appeal Board Case No. 46,555-54

SUPREME COURT
APPELLATE DIVISION
THIRD JUDICIAL DEPARTMENT

Decision handed down November 23, 1955

In the Matter of the Liability for Unemployment Insurance Contributions under Article 18 of the Labor Law of SAVOY BALLROOM CORP., Appellant, ISADOR LUBIN, as Industrial Commissioner, Respondent.

Decision of the Unemployment Insurance Appeal Board reversed, and the matter remitted to the Board for further proceedings, without costs.

Opinion by Halpern, J. Foster, P.J., Bergan, Coon and Zeller, JJ., concur.

Halpern, J.

This case brings up for review the unfortunate conflict which has developed between the federal and state authorities with respect to liability for unemployment insurance contributions upon the compensation paid to members of so-called "name" bands.

The proprietor of a public dance hall or ballroom customarily enters into a contract with the leader of the orchestra under a standard form contract prescribed by the American Federation of Musicians known as Form B. This contract was promulgated by the Union after the Federal Courts had held that, under the form of contract theretofore used, the leader of the band was the employer and was liable for social security taxes on the salaries paid to the members of the band (*Spillson* vs. *Smith,* 147 Fed. 2d 727; *Williams* vs. *United States,* 126 Fed. 2nd 129; *Biltgen* vs. *Reynolds,* 58 Fed. Supp. 909; *Los Angeles Athletic Club* vs. *United States,* 54 Fed. Supp. 702; *Aberdeen Aerie No. 24 F.O.E.* vs. *United States,* 50 Fed. Supp. 734; *re Ten Eyck Co.,* 41 Fed. Supp. 375). The Form B contract was concededly designed to make it appear that the dance hall or ballroom operator was the employer, so that he would be the one held liable for social security taxes and unemployment insurance contributions. The contract applied the designation of "employer" to the operator and it contained the provision that "the employer shall at all times have complete control of the services which the employees will render under the specifications of this contract."

The actual realities of the situation were, however, as shown by the record in this case and by the record in (*Bartels* vs. *Birmingham,* 332 U.S. 126) *infra,* that the leader was the owner of an independent enterprise and that he chose the members of the band and replaced them from time to time in accordance with his own wishes. The contracts usually called for the payment to the leader of a fixed sum either as a complete payment or as a guarantee against a share of the gross receipts. The leader paid the weekly salaries of the members of the band, in accordance with the Union scale, and retained, as his profit, the difference between the contract price and the total compensation paid and incidental expenses. The leader usually entered into a number of short term engagements with different dance hall or ballroom operators; the relations between the leader and the other members of the band were fairly permanent; those between the band and the operator were transient (*Bartels* vs. *Birmingham,* 332 U.S. 126). In order to reconcile the contract designation of the operator as the employer with the actual realities, the contract provided that, in employing the musicians and in distributing their pay to them, the leader acted as the agent of the operator.

After the adoption of the Form B contract, the Commissioner of Internal Revenue issued interpretive rulings in 1944 holding that, under the contract, the ballroom operator was to be regarded as the employer for federal social security and unemployment insurance tax purposes (Cum. Bull. 1944, pp. 547, 548). However, on June 23, 1947, the United States Supreme Court held that these rulings were erroneous and that, notwithstanding the terms of the contract, the orchestra leader was not the employee of the operator but was an independent contractor and that he was the actual employer of the members of the band. The Court held that the leader was liable for federal social security and unemployment insurance taxes and that the parties could not by contract shift the tax liability from the leader to the ballroom operator (*Bartels* vs. *Birmingham, supra*).

In the meantime, the question of liability for unemployment insurance contributions under the New York Unemployment Insurance Law (Labor Law, Art. 18) had arisen in New York State. The New York Unemployment Insurance Appeal Board had held, even under the contracts used before the adoption of the Form B contract, that where the contract had incorporated by reference the Union by-laws which designated the operator as the employer and the leader as his agent, the operator was liable for unemployment insurance contributions under the New York law. The courts sustained these decisions of the Board (*Matter of Camgros,* 264 A.D. 973, aff'd. in part 290 N.Y. 838; *Matter of Roseland Amusement Co.,* 269 A.D. 713 aff'd. 295 N.Y. 913; but compare *Matter of Earle,* 262 A.D. 789, aff'd. 286 N.Y. 610).

The first case to reach the courts under the Form B contract was *Matter of Hotels Statler Co., Inc.,* 279 A.D. 814 (January, 1952; leave to appeal denied 304 N.Y. 987). That case arose after the decision by the United States Supreme Court in the *Bartels* case. The Referee in the *Statler* case held that, notwithstanding the decision by the Supreme Court, the contract provision vesting the right to control in the operator, designated in the contract as the employer, was sufficient in and of itself to make the operator liable for unemployment insurance contributions. He declined to follow the Supreme Court's decision upon the ground that the question was one of state law and that the Supreme Court's decision had no binding force. The Appeal Board affirmed the Referee's decision but added a finding that the hotel had, in fact, exercised control over the performance by the musicians during the period of the contract. Upon appeal to this Court, the Court did not approve the broad position taken by the Referee (and affirmed by the Board) but it nevertheless affirmed the Board's decision upon the ground that it was "within the realm of fact". The decision of the Appeal Board was "final on all questions of fact" (§ 623, Labor Law) and, if the decision was supported by substantial evidence, the Court was powerless to disturb it. The Court pointed out that "There is some evidence of rather trifling acts of control on the part of the management of the hotels where the orchestras played". The Court noted that the Board had not "made any attempt realistically to appraise the relationship in the light of common-law principles, as was done in the case of *Bartels* vs. *Birmingham* (332 U.S. 126)" but it nevertheless held that the Board had the power to decide as a matter of fact that the operator was the employer and that the leader and the members of the band were its employees.

After the decision of the *Bartels* case in 1947, the Union, representing the orchestra leaders, sought to find a way to protect them against the liability resulting from that decision. As appears from the proof in the present case, in 1949, the Union prepared two riders designated Riders A and B, respectively, one of which was to be affixed to the Union's Form B contract in accordance with the choice made by the operator. By Rider A, the Union attempted again to make the ballroom operator the employer, despite the *Bartels* decision. It designated him as the employer in the rider and required him to agree to pay "all taxes and

contributions payable by employers under any Federal or State Law applicable to the services performed under the contract". On the other hand, Rider B accepted the *Bartels* decision, declaring the leader to be the employer, but it required the operator to pay an additional sum to the leader to make up for his added liability. Rider B read as follows:

> "Notwithstanding any other provision contained in this contract, it is agreed that the leader shall make the withholdings and pay the taxes and contributions payable by an employer with reference to the employment of the musicians other than himself. In the event that at any time liability for any such payments or withholdings shall be imposed on the purchaser of the music, the leader agrees to transfer any and all tax accounts to the name and credit of the purchaser of the musicians [sic]. It is further agreed that the price stated upon the face of the contract is hereby increased at an amount equal to 7% of such price as so stated, which sum shall be paid to the leader as an additional compensation.
>
> .....
> Purchaser of the Music
>
> .....
> Leader

In the present case, the Savoy Ballroom Corp., the appellant, elected to take the Form B Rider and throughout the period from January 1, 1950, to June 30, 1951, which is in controversy here, it entered into various Form B contracts with orchestra leaders with Rider B attached.* Also, the leader in each case signed a receipt for the moneys received by him from the appellant reading as follows:

> "The undersigned agrees that he is the employer of the band and will be responsible for all Social Security, Unemployment Insurance and Withholding Taxes as the employer."

It will be noted that, under Rider B, the ballroom operator is no longer designated as the employer but as the purchaser of the music both in the text and in the descriptive title following the place for signature and it will also be noted that the terms of the Rider are to override "any other provision contained in this contract".

The *Statler* case had been decided against the hotel by the Unemployment Insurance Referee on March 3, 1949, prior to the promulgation of the riders. Of course, the Form B contracts which were involved in the *Statler* case did not have any rider attached to them. No decision had as yet been made by the Board or by the courts in the *Statler* case at the time that the riders were promulgated by the Union.

Under Rider B, an additional 7% of the contract price was to be paid by the operator to the leader. Out of this, the latter was expected to pay 1½% for social security taxes to the federal government, 2.7% to the state of New York for unemployment insurance contributions and 3/10th of 1% to the federal government for unemployment insurance taxes (the federal tax of 3% less credit for 2.7% paid to the state). The balance of 2½% was to be retained by the leader as reimbursement for the cost of bookkeeping and accounting.

In arriving at the 7% additional payment, the parties apparently assumed that the federal and state decisions would be in harmony and that the leader would be held to be the employer by both the federal and state authorities. However, the parties contemplated the possibility that the *Barteis* case might be overruled by a subsequent decision or statutory amendment and that the operator might again be held to be the employer, and the rider therefore contained a provision that, in that event, the leader would transfer to the purchaser the additional moneys paid to him for taxes. This reimbursement clause turned out to be ineffective when the state and federal authorities took different views, the State Board holding that the operator was the employer, and the federal authorities continuing to follow the *Bartels* case. The leader was then required to pay the full 3% federal tax to the federal authorities, under their holding that he was the employer, and there was nothing left in his hands to repay to the operator to discharge the operator's state liability.

The Referee held in the present case that the rider did not have any effect upon the relationship between the parties and that the operator was still liable under the state law for unemployment insurance contributions as the employer. The Board affirmed upon the opinion of the Referee, which read as follows:

* This case involved assessments for unemployment insurance contributions for the period from January 1, 1947, to June 30, 1951, but the appeal is taken only from that part of the decision which relates to the period from January 1, 1950, to June 30, 1951, the period during which the Rider B was used. The appellant has conceded liability with respect to the period from January 1, 1947, to December 31, 1949, so that no question as to that period is before us.

"The *Statler* case is a binding authority for holding the employer herein, the purchaser of music under a form "B" contract, to be the employer of the musicians. The rider did not divest it of its status as employer. It is unnecessary to make any finding as to whether or not the employer herein in fact exercised supervision and control over the manner in which the musicians rendered services at its dance hall."

We take it that the last sentence of this opinion means that the Referee not only found it unnecessary to make any finding as to whether the employer had in fact exercised supervision and control but also that he found it unnecessary to make any finding as to whether the employer, in fact, *had any right* to supervise and control the manner in which the musicians rendered their services. The Referee apparently interpreted the Court's decision in the *Statler* case as meaning that, as a matter of law, under a Form B contract, the operator was to be treated as the employer for unemployment insurance purposes, regardless of whether he was in fact the employer. Since, according to the Referee's view, the rider left the Form B contract still in force, the operator was still liable for the unemployment insurance contributions.

First of all, we believe that the Referee and the Board took too broad a view of the decision of this Court in the *Statler* case. We affirmed the Board's decision in the *Statler* case solely upon the ground that the decision lay within the realm of fact and that, upon the record before the Board in that case, there was substantial evidence to support the finding that the operator was the employer. The Court did not treat the contract terms as in and of themselves controlling, as the Referee and the Board had done. The contract terms, under the Court's decision in the *Statler* case, merely constituted elements to be considered in deciding the overall question of fact as to the true nature of the relationship. In this respect, the Court followed the principle laid down in *Matter of Morton,* 284 N.Y. 167, 175: "no written agreement may preclude an examination to determine whether the actual relationship is such as to bring the parties within the scope of the law." (See also *Matter of Electrolux Corp.,* 288 N.Y. 440, 444; *Matter of Realty Hotels* vs. *Corsi,* 285 A.D. 919.)

Secondly, the Board in this case erred in rejecting the rider as having no significance. The rider nullified any inference that the operator was in fact the employer, which might otherwise have been drawn from the designation of the operator as the "employer" in the main contract. The rider designated the operator as the purchaser of the music rather than as the employer of the musicians. This was re-inforced by the form of the receipt signed by the leader which specifically stated that he was the employer. While the rider is not as explicit as it might have been, it should be borne in mind that it was drawn by the Union and that the operator did not have any opportunity to participate in its phrasing. The rider did not expressly negate the provision in the main contract that "The employer shall at all times have complete control of the services" of the musicians but it will be noted that the provision as to control is tied to the designation of the operator as the employer and it may reasonably be concluded that when that designation was withdrawn by the rider, the provision as to control fell with it. This conclusion may the more readily be reached because of the fact that, as shown by the proof, the provision was only a fiction to begin with, designed to make the purchaser of the music the employer for tax purposes but never really intended to vest the right of control in him. The evidence in this record is overwhelmingly clear that the operator did not in fact have any right to control the manner of performance of the services under the contract. The contract provision, which had been given so much weight in the earlier cases, having been in effect overriden by the rider, there is no basis in the present record for a finding of fact that the operator was the employer. Indeed, as we have noted, the Referee and the Board have not even undertaken to make a finding of fact in this case on the issue of the actual relationship.

The rider in this case is substantially different from that before this Court in the *Matter of Cassetta,* 282 A.D. 793, leave to appeal denied 306 N. Y. 982. In that case, the rider simply stated that the leader "acknowledges that he conducts 'a name band' and is therefore responsible for Social Security taxes and Unemployment taxes". This was held to be an invalid attempt to shift liability from the employer to one who was in fact not the employer. The rider did not purport to qualify in any way the provisions of the contract designating the operator as the employer. Furthermore, the Board had made a factual finding upon the evidence that the operator was the employer and the Court said: "If in fact, they [the musicians] are employees of the hotel, any acknowledgment which might be construed to the contrary does not alter their status."

If the Board's decision in the present case is allowed to stand, the situation will be an extremely unsatisfactory one. The leader is not given any credit on his federal tax liability for the payment made to the state by the operator since the payment is not made by the same employer. The leader therefore pays 3% to the federal govern-

ment for unemployment insurance, and the operator pays 2.7% to the state. A total of 5.7% is thus paid upon the compensation of the musicians contrary to the scheme of the unemployment insurance law, which contemplates a total payment of 3%. The statutes provide for a payment of 2.7% to the state and a credit for this payment against the federal 3% tax, under the 90% credit clause, so that only 3/10th of 1% remains to be paid to the federal government.

Under the Board's decision, the operator's payment to the state is computed not only upon the compensation paid to the musicians but also upon the balance of the contract price retained by the leader himself. This is, of course, improper if the leader is in fact an independent contractor and not an employee of the operator. The operator is required to pay the 2.7% to the state in addition to the 7% paid to the leader under the rider, supposedly in full for all state and federal taxes. The operator thus pays a total of 9.7% of the contract price. He is worse off under this interpretation of the contract and rider than if he were held to be the employer in fact for both state and federal purposes.

The need for harmonizing the federal and state decisions is self-evident. The state and federal statutes are integral parts of a single scheme. "State and federal unemployment relief systems . . . [are] integrated in plan, function and purpose" (*Illinois* vs. *United States,* 328 U.S. 8, 11). If it is possible to do so, the state and federal authorities ought to reach the same conclusion with respect to the identity of the employer so that overpayments of taxes may be avoided (*Matter of Rogers,* 269 A.D. 551, aff'd. 296 N.Y. 676). There is no substantial difference between the state and federal statutes which warrants different conclusions.* "While Federal . . . decisions are not binding on us they are highly persuasive and uniformity in interpretation is desirable" (*Matter of Lazarus,* 268 A.D. 547, aff'd. 294 N.Y. 613). Of course, there is always the possibility that a factual question may be decided differently by two different triers of the facts but that does not seem to be the cause of the present difficulty. The cause is rather the assumption by the Board (1) that, as a matter of law, the Form B contract makes the operator the employer and (2) that this ruling is unaffected by the addition of Rider B. As we have seen, both propositions are erroneous. The Board should decide the question of the true relationship as a question of fact, not only in the light of the Form B contract but also in the light of the Rider B and the receipt, and in the light of the evidence as to the actual intent of the parties.

The decision of the Unemployment Insurance Appeal Board should be reversed and the case remitted to the Board for further proceedings, without costs.

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* Subsequent to the decision of the *Bartels* case, Congress adopted an amendment to the federal act so as to provide specifically that the term employee was not to include "(1) Any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an independent contractor (2) Any individual (except the officer of a corporation) who is not an employee under such common law rules" (Amendment adopted June 14, 1948, to §§ 1607 (i) and 1426 (d) of the Internal Revenue Code, Title 26 U.S.C.). This amendment did not in any way affect the holding in the *Bartels* case. The amendment was designed rather to overcome the effect of *United States* vs. *Silk,* 331 U.S. 704, which held that even if the owner of an enterprise was not an employer under the common law test, he might be held to be an employer in the light of "economic realities" for the purpose of determining the coverage of the Social Security Act. When the Treasury Department proposed new social security and unemployment insurance regulations incorporating this view, Congress reacted by the adoption of the statutory amendments, reaffirming the controlling force of the common law test. While in the *Bartels* case, the Court referred to the "economic realities" rule under the *Silk* case, its holding that the band leader was the employer was amply justified under the common law test and was not dependent upon any extended concept of the employer-employee relationship. The Court held that it was the duty of the taxing authorities to go behind the contract terms and to ascertain the true situation; when this was done, it was evident that the leader was the true employer.

In any event, the amendment to the federal statute now clearly makes the common law test controlling so that the test is the same under the state and federal law. The federal authorities have consistently held the leader to be the employer since 1947 (Mimeograph Coll. No. 6187).

Official Decisions and Releases

STATEMENTS ON AUDITING PROCEDURE **April, 1956** **No. 26**

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Issued by the

Committee on Auditing Procedure, American Institute of Accountants, 270 Madison Avenue, New York 16, N.Y.

Reporting on Use of "Other Procedures"

1. In 1939 the membership of the Institute approved the extension of auditing procedures to require observation of inventories and confirmation of receivables where either of these assets represents a significant proportion of the current assets or of the total assets of a concern.

2. These procedures were thus established as an integral part of generally accepted auditing procedures. Failure to apply them, where they are practicable and reasonable, in general precludes expression of an opinion on the fairness of the financial statements taken as a whole.

3. *Codification of Statements on Auditing Procedure* states (third and fourth paragraphs on page 21):

> "In all cases in which the extended procedures are not carried out with respect to inventories or receivables at the end of the period or year, and they are a material factor, the independent certified public accountant should disclose, in the general scope section of his report, whether short or long form, the omission of the procedures, regardless of whether or not they are practicable and reasonable and even though he may have satisfied himself by other methods.
>
> "In the rare situation in which they are applicable and are not used and other procedures can be employed which will enable him to express an opinion, he should, if the inventories or receivables are material in amount, disclose the omission of the procedures in the general scope paragraph without any qualification in the opinion paragraph with respect to such omission. In deciding upon the 'other procedures' to be employed he must bear in mind that he has the burden of justifying the opinion expressed."

4. It has become increasingly evident in those instances where the accountant's report has disclosed omission of the extended procedures that, in the minds of a number of interested parties, including important groups of credit grantors, uncertainty often exists as to whether or not the accountant did actually undertake other auditing procedures.

5. Accordingly, it is the view of the committee that, *in all cases* in which the extended procedures are not carried out with respect to inventories or receivables as at the end of the period or year [1] and they are a material factor, the independent certified public accountant should not only disclose, in the general scope section of his report, whether short or long form, the omission of the procedures, regardless of whether or not they are practicable and reasonable, but also should state that he has satisfied himself by means of other auditing procedures if he intends to express an unqualified opinion. The second sentence of the scope paragraph of the independent auditor's report will then read somewhat as follows:

> "Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances; however, it was not practicable to confirm receivables (to observe the physical inventory taking), as to which we have satisfied ourselves by means of other auditing procedures."

In these circumstances, no exception would be required in the opinion section of the report.

6. *Codification of Statements on Auditing Procedure* points out that "other procedures" can be satisfactorily employed only in *rare* situations in which the "extended procedures" are applicable and are not used. It is not the intention of the committee to withdraw in any way from its previous conclusion in this respect.

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[1] Under appropriate circumstances, the procedures may be carried out at times other than at the end of the period or year.

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